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INTERNATIONAL AND DOMESTIC MONETARY REFORM

In recent weeks, there has been much discussion regarding the possibility of using a market basket of commodities, including gold, to guide the monetary policies of the major industrial nations. U.S. Treasury Secretary James Baker, French Finance Minister Edouard Balladur, members of the Federal Reserve Board, and others have spoken approvingly of the concept. At the moment, the driving force behind the proposal is not a great fear of renewed worldwide inflation, but the concern over wildly fluctuating exchange rates. Wide swings in exchange rates diminish worldwide economic growth since they increase the risk of investment anywhere in the world. This, in turn, leads to lower levels of investment and productivity growth.

As a long time advocate of using internationally traded commodities as a guide for monetary policy, I am, of course, pleased with the recent interest in the approach. However, I urge policymakers to proceed with caution since much empirical work remains to be done in this area before a commodity basket can become a useful policy tool. The fundamental problem with any commodity basket is that commodity prices lag changes in money growth rates. Hence, great care must be taken to design a basket which minimizes the lag.

In the early spring of 1984, Ronald Utt and I co-authored a paper entitled, *Monetary Reform: A Proposal for Bringing Price and Quantity Rules Together,* a condensed version, of which is reprinted following this. The paper described how a basket of traded commodities could serve as a useful guide for monetary policy. We did not explicitly note the benefits for exchange rate stability if the major industrial countries would adopt approximately the same basket of internationally traded commodities for their respective price rules. We also did not note the difficulties of imposing such a rule on only one economy without similar rules in the other major countries. Finally, we did not fully explain that price levels can be held constant at various levels of economic activity, and that the goal of economic policymakers ought to be price stability at a high level of economic growth. In fact, the major reason to oppose high rates of inflation or deflation is because price instability confuses the information business people need to make rational economic decisions. This causes economies to perform at lower real levels than they otherwise would. If policymakers attempt to implement the following proposal, they must always remain cognizant of the fact that their fundamental long run goal should be to increase real per capita incomes as rapidly as possible.

Richard W. Rahn

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MONETARY REFORM:
A PROPOSAL FOR BRINGING PRICE AND QUANTITY RULES TOGETHER

by

Richard W. Rahn and Ronald D. Utt *

(March 1984)

As has happened so frequently over the past several decades, monetary policy and the behavior of the Federal Reserve are once again at the center of debate as our policymakers consider the prospects for perpetuating a sustained recovery with stable prices.

Critics of the Federal Reserve fall into two main groups. In the first are advocates of discretionary policy who simply want a different policy from that now being pursued. They say that all would be well if only the right people -- themselves -- were in charge. The second group includes all those who distrust unconstrained Federal Reserve power. They are not interested in seizing monetary powers themselves, for they know that in our vigorous democratic system it is impossible to guarantee that the "right" people will always be in charge. They understand that the substitution of the rule of law for the rule of officials is the essence of democratic reform. This second group has grown enormously over the last fifteen years as the failures of discretionary economic management have accumulated. A much deeper appreciation of the constitutional role of the gold standard over our history has emerged as experience with unbridled discretion has accumulated. But this second group, the constitutionalists, is badly split over what rule should replace discretion. Arguments over the rule -- whether it should be a price rule or quantity of money rule -- have prevented any rule from replacing a monetary policy guided by no rule.

The failure to resolve this debate among those who harbor a deep suspicion of the Fed's ability to fulfill successfully its chief responsibilities under present institutional arrangements is an inexcusable misfortune. The failure represents missed opportunities whose costs can be measured in the debasement of our currency, lost jobs, capricious shifts of wealth between sectors of our society and lower incomes for our citizens. This persistent failure to agree on a solution by both price rule and quantity rule advocates is surprising inasmuch as the opposing groups have so much in common. Both sides view the Fed's central responsibility as one of maintaining stable prices, and both agree that sustained inflation is a monetary phenomenon. But beyond these axioms, the agreement collapses as opposing groups disagree on the mechanics of how one implements the objective of price stability.

In an effort to resolve this debate, we have developed a proposal that we believe could accommodate both factions and substantially improve the course of future monetary policy. Combining both elements of a price rule and a quantity rule, we believe that this proposal would be superior to either rule taken individually and certainly superior to a continuation of a policy wholly dependent upon the discretion of the Fed -- a policy guided by no rule. In this article, we first define the monetary policy problem and then discuss in detail how our proposal would address that problem and the apparently intractable debate that now consumes the groups that ought to be united in seeking a solution.

A Problem Emerges, Again

The fundamental problem of our monetary arrangements -- the absence of any rule or standard -- becomes painfully clear from time to time, and then seems to slip into the background.

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This is not the place to recount the history of these episodes that bring our fundamental monetary problem into focus -- although doing so would demonstrate that today's situation is not unusual -- but it is helpful to discuss the present episode in some detail in order to understand the value of the proposed rule.

Following a period of relative calm, there has emerged in recent months both grave concern and general dissatisfaction with the recent course of monetary policy. There are many sources of concern. They range from the absence of a discernible policy direction to recent statements by members of the Board of Governors implying that an accommodative monetary policy will be held hostage to meaningful congressional action on the budget deficit, which action might well include counter-productive tax increases. Heightening these concerns is the upward drift in interest rates, a depreciating dollar, increases in commodity prices, and a general sense of unease that is spreading through financial markets.

What is apparent in reviewing both the Fed's performance and the deliberations of the Federal Open Market Committee is that the Fed is acting in a highly discretionary manner, attempting to manage the course of the U.S. economy according to its own judgment of where the economy is now and where it will be in the next quarter or two. In short, there appears to be little or no recognition that sustained inflation is always and everywhere a monetary phenomenon and that trends in the real economy, when divorced from changes in money growth, have little bearing on past, present and future inflation.

This approach to policy leaves the Fed rudderless. It is impossible for the Fed itself to predict its own future actions. Because it cannot predict its own actions, and will not commit itself, its public stance is one of obfuscation. It reports "ranges" -- the word "target" has disappeared -- for four different monetary and credit variables. Those ranges are subject to revision at any time. Alleged difficulties in defining, measuring, and controlling money are used to "explain" why money growth surges or sags. Because the Fed is rudderless, the market has absolutely no way to predict the future course of money growth, the price level, interest rates, or the level of economic activity.

Desperately Needed: A Solution

Many had thought that the problem of determining the proper course for monetary policy had been resolved in October, 1979, when the Fed appeared serious about acheiving a target growth rate for M_1 that was consistent with a gradual deceleration in inflation.

In changing its operating procedures in 1979, the Fed implied that it would seek more stable growth in the monetary aggregates and would eschew interest rate targets and fine tuning of the economy. In practice, however, this new policy, as implemented by the Fed, led to exceptionally erratic month-to-month and quarter-to-quarter changes in M_1 that we and many others believe was a key contributor to the depth and duration of the recession and high real interest rates. The October, 1979, policies were described by many as "monetarist", but that designation is wrong. Money growth became less rather than more stable and predictable.

Despite the fact that the restraint on monetary growth contributed to dramatic declines in both inflation and interest rates in 1981-1982, monetarism became associated with recessionary policies, and public support for monetary targeting evaporated over concern for high unemployment and negative real growth. The Fed was only too happy to comply with public and congressional concerns by abandoning any attempt to hit monetary growth targets. It quickly reverted to past policies of attempting to fine tune the economy by targeting the Fed funds rate.

In recognition of the damage that could follow from a Federal Reserve operating in an environment devoid of any rules and guidance, we propose a new set of procedures that are founded in two principal axioms that most economists accept:

1) The chief responsibility of the Federal Reserve Board is the maintenance of price stability; and

2) Sustained inflation is largely a monetary phenomenon.

It follows, then, that the course of monetary policy should be guided by rules that relate primarily and directly to prices and that some index of sensitive prices would be ideally suited as the chief indicator to guide the Fed. But what the Fed actually controls day to day is its own portfolio. The Fed does not buy and sell commodities with sensitive prices, but government securities. Accountability under a rule requires that the rule link the price objective to the Fed's open market operations in government securities.

The recommendation that the Federal Reserve stabilize prices has been made by others in the past only to be rejected by the traditional monetarists who believed that steady money growth at a low rate would be sufficient to achieve sustained price stability. With our monetarist sympathies, we, too, felt this way, believing that the inclusion of additional policy indicators simply confused the issue, and that the attainment of the announced moderate money growth targets would be more than adequate to ensure price stability. In short, we continued to believe that the Fed would adhere to its own announced money growth targets.

In retrospect, however, this outcome did not materialize. Publicly-announced monetary targets have been in force since 1975, but the Fed has been unwilling to meet them in a consistent fashion. Monetary growth, as measured by M_1, has been highly erratic, creating uncertainty in financial markets. Indeed, the case can be made that the announced targets have had no effect whatsoever on Fed policy.

From this experience, we have come to the conclusion that firmer limits must quickly be imposed on the Fed to ensure accountability and the implementation of monetary policies consistent with certainty, stable prices and sustained economic growth. Constitutionalists must find a way of joining together to define a compromise rule. The debate over what rule is optimal should be suspended temporarily in order to construct a rule that is better than the absolute discretion that now determines monetary policy.

The basic features of a compromise rule must reflect the following considerations. First, monetarists insist that a rule must be defined, operationally, in terms of Federal Reserve control over money growth. This position reflects their views on monetary theory and, most importantly in the present context, the fact that the Fed has the technical means for controlling money growth. Under present circumstances, the only magnitude the Fed can be held strictly accountable for controlling is the M_1 definition of money or alternatively, the monetary base on bank reserves.

Second, monetarists have always been less interested in a *constant* money growth rule than in a *defined* rule. That is the point where there is ample room for quantity rule and price rule advocates to come together. To limit Federal Reserve discretion, price rule advocates must in any case define what the Fed should do, operationally, when prices are rising or falling. What is the measure of a "tighter" or "easier" policy?

Price rule advocates fear a constant money growth rule because it makes no allowance for money demand shifts. They believe that it makes no sense to hold money growth constant when the behavior of prices clearly signals inflation or deflation ahead. If prices are tending to rise because money demand is falling, then the money supply must fall to stabilize prices, and vice versa. The essence of the problem is to define a rule whereby money growth rises when there are downward pressures on prices, and falls when there are upward pressures on prices.

To implement a policy based on the price rule, an index of sensitive commodity prices, which could consist of a basket of widely traded commodities or precious metals or some combination of the two, would be designated as the chief indicator of required monetary ease or restraint. Since the prices of various commodities tend to respond with different lags to changes in the money supply, the commodities included in the basket should be limited to those whose prices respond quickly to economic circumstances. Minimal time lags are crucial to allow for the quick implementation of a change in monetary policy and to avoid the destabilizing effect of tying money growth to prices that respond with a lag. Commodities that should be excluded from such an index are those that are extremely sensitive to political changes independent of the course of monetary policy. Energy prices, for example, are highly sensitive to political factors. Many commodities with sensitive prices are, of course, subject to volatile supply conditions, as with food. To prevent false signals due to supply disturbances, the index should include a diversified list of commodity prices, and commodities particularly subject to supply disturbances should receive less weight in the index.

With such an index established as the indicator of appropriate monetary ease or restraint, the Federal Reserve would be required to stabilize this index within some permissable target band by adjusting the rate of money growth. Should the index exceed the upper limit of the band for some specified period of time, the Fed would impose firmer limits on monetary growth until the index returned to within the target band. Likewise, should the index fall below the bottom limit of the band, the Fed would raise money growth until the index rose to within the target range. With changes in the index available on a daily basis, the Fed would have instant access to market trends and the market's reaction to its policies. The changes in money growth required of the Fed would be carefully specified so that financial markets would not be surprised or faced with additional uncertainty.

To avoid the extreme gyrations in policy, the rule would call for moderate changes in money growth on the basis of the price index signal. This could be done in one of two ways. First, the existing form of target ranges for M_1 growth could be narrowed to a range estimated to be consistent with stability in the commodity price index. This range, however, could be adjusted periodically if the range were found to be overly restrictive or accommodative. Suppose, for example, that the price index were falling while M_1 growth remained at the top of the range. This combination might suggest that the M_1 range was misspecified or that there had been a shift in the demand for money since the initial range had been established. As a result, the target range for M_1 would be adjusted upward by, say, one percentage point. Prices might then be stabilized within their target range and the new target range for M_1 would be maintained as long as prices remained stable. If the one percentage point adjustment were not sufficient, the range would be subject to further adjustment after some specified period of time, say six months.

Another alternative, suggested by Robert Genetski, would allow the Fed a "range of discretion" regarding the creation of money. His range is expressed in terms of the monetary base and would limit the Fed to making changes in the monetary base of between \$0 and \$1 billion on a monthly basis. That is, in any month, the monetary base could not decline nor could it rise by more than \$1 billion. The range of discretion could change automatically in response to changes in the index of sensitive commodity prices. Specified percentage increases in the index would lead to a progressive lowering of the monthly range of discretion until prices were stabilized, while specified decreases in the price index would lead to progressive increases in the range of discretion. Obviously, the same mechanism could be incorporated when target growth ranges for M_1 represented the target defining the range of discretion. Genetski prefers the monetary base to M_1 because it is less likely to be subject to definitional uncertainties and is easier to control than M_1.

An obvious objection that could be made by both traditional monetarists and advocates of a formal price rule is that this proposed system, by focusing on both quantity and price, attempts the impossible. They would note, quite correctly, that the central bank can meet a price target or a quantity target, but not both. Price advocates would argue that the goal of price stability is sufficient and any attempt to focus on money as a target could lead to financial instability if the target was incorrectly specified. Similarly, monetarists would argue that steady and moderate growth in M_1 would automatically lead to stable prices.

While there is merit to both views, there are a number of good economic, political and institutional reasons for attempting to monitor and influence both price and M_1 on the basis of limited discretion. The first reason is that neither of these variables is an infallible target or indicator and any attempt to limit discretion to one or the other could lead to severe problems if the objective was misspecified or if nonmonetary influences became prominent at various points in time. While inflation is a monetary phenomenon, many other factors also come to bear on the price of any commodity. Supply shocks, changes in exchange rates and international instability could disrupt commodity markets, send the wrong signals to the Fed and force it into a policy that may disrupt the economy. Likewise, in a regime characterized by a rule holding money growth in a narrow range, shifts in the demand for money could lead to rising or falling prices if quantity targets are adhered to with no regard whatsoever to price signals. In either case, the misspecification of targets could lead to economic problems.

Second, a single, rigid target would, ironically, still allow the Fed too much discretion. Anyone who has followed Fed behavior for the past many years recognizes that the Fed is remarkably adept at developing and successfully marketing all manner of excuses to justify its mistakes and its failure to act according to previous commitments. Moreover, there is no shortage of economists, politicians and financial market participants willing to accept these excuses and add further justifications for them. In a democratic society, any rule, regardless of how appropriate it might be, is enforceable only if it receives support from the vast majority of those who have an interest in the issue or institution being restrained. If a rule does not command wide support, then it will be flaunted at will whenever it is convenient to do so, and all sorts of good excuses to justify its violation will be developed.

One can easily envision the same sort of behavior under a price rule. Suppose, for example, that the designated price index began to rise and that the Fed took no action to reestablish stability. When confronted with evidence of rule violation, the Fed could raise any number of extenuating factors to justify its behavior. Wars in the Middle East, financial difficulties in developing countries, and technological innovations could all be used to explain short-run changes in a price index that most recognize to be potentially volatile and subject to influences beyond the monetary policies of a single nation. As in the past, the interested public would accept these excuses, at least temporarily, and Fed policy would again revert to purely discretionary standards of behavior.

The beauty of a well-defined standard relying on multiple indicators is that one would serve as a check on the other and diminish the Fed's degree of freedom to develop seemingly plausible excuses to justify the violation. But a rule, to be politically viable, must be simple enough to be understandable. A two-indicator rule, focusing on money growth and sensitive prices, probably accomplishes 95 percent of what might in principle be done with a far more complex rule. A combination price and quantity rule is sensible and understandable; a voter does not need a Ph.D. in economics to evaluate such a rule. At the same time, it would allow the Fed some minimal amount of flexibility to use its discretion in adjusting for special influences on both price and/or quantity. If, for example, the price index wandered toward the upper limit of its band, the Fed might take no action because it felt that nonmonetary factors were the cause. But if the Fed's judgment were wrong and the price index broke through its upper limit, the rule would require that money growth be slowed somewhat.

Options for periodic review and revision of target ranges are essential if we are to monitor and influence both price and quantity. No legislated rule, not even a constitutional amendment, is enacted for all time without possiblity for change. With experience, the price/quantity rule may be changed. As long as the ranges encompass the likely equilibrium point and are adjusted when fundamental changes occur, this policy mechanism will not force the Fed to accomplish the impossible. But if experience demonstrates that the price index should trigger either larger or smaller changes in money growth, so be it. The fact that a rule might have to be changed is never an argument for having no rule at all. With the proposed combination rule, the Fed would be held to a responsible and workable standard of accountability that is superior to the present system of unchecked discretion.

Proponents of price and quantity rules will continue to debate the relative merits of these rules. The introduction of a combination rule can begin an evolutionary process that, through experience, may lead to adjustments in the combination rule toward either a price rule or a quantity rule. But unless rule advocates can agree on a combination rule, the debate will remain an academic one.

The End Result

It is our belief that the implementation of a set of guidelines modeled on the above proposal would lead to a monetary policy far superior to that of the last two decades. As we look at the performance of the economy during the postwar era, we cannot help but conclude that the Federal Reserve played an important role in exacerbating the cyclical tendencies inherent in the U.S. economy. This pattern has been especially clear since 1965. By stimulating recoveries well beyond the point where inflation becomes a problem, the Fed has then been forced to adopt policies of severe stringency to reduce the inflation that it largely induced. Left to its own judgment, the Fed will persist in the roller coaster policy of ease and restraint and the U.S. and world economies will suffer accordingly.

With our proposal there would be little likelihood of these periodic bouts of austerity occuring inasmuch as adherence to the proposed guidelines would ensure that inflation never got out of control. Essential to eliminating the "stop" phase of the cycle is eliminating the "go" phase. Monetary restraint must be applied gradually when inflation problems first emerge and are easier to cure. The political problems that invariably arise whenever the Fed leans toward restraint, no matter how minor, would also diminish since its actions are now mandated by the rule.

Another major advantage would be the financial market's renewed sense of confidence in the Fed. With reasonably firm rules guiding Fed actions, there would be no need constantly to guess what policy the Fed is pursuing at any given time and how the Fed will react to a wide variety of economic events. Future Fed actions could be estimated with a greater degree of certainty and interest rates would decline as financial market participants realized that risk premiums were no longer required as a protection against unanticipated Fed policy changes.

All rule advocates recognize that their own favorite rules have at times provided misleading guidance. But a rule is not desirable because it is infallible; the issue is the alternative. The advocates of a price rule should decide whether the present discretionary system is better than a quantity rule, and the advocates of a quantity rule should ask the corresponding question about a price rule. By refusing to face those questions, price rule and quantity rule advocates permit discretion to win by default. The founding fathers recognized full well what government by discretion was all about. Surely price rule and quantity rule advocates can construct a combination, or compromise, monetary rule. That is what this paper is all about.

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AMERICA'S INTERNATIONAL POSITION: DEBTOR OR CREDITOR?

by
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Assertions have been made that in 1985, for the first time in 65 years, America's net foreign assets position shifted from that of a net creditor to a net debtor. Moreover, when all the numbers were added up and compared, many observers claimed that the United States emerged, not only as a debtor country, but as the world's largest debtor. Brazil, whose moratorium on debt service payments last February continues to cause consternation in financial circles, has a total foreign debt which is only a little over two-fifths of the U.S. debt.

This development has led to a multitude of articles detailing the "foreign flags flying over the American economy," and presaging dire consequences when the "day of reckoning" arrives. The implication is twofold: first, that foreign direct investment (FDI) in the United States is harmful; and second, that at some future date our descendants will be faced with the burden of repaying our extravagances, and will experience the same hardship that the Mexicans, Brazilians and citizens of other indebted developing countries are suffering today.

This paper demonstrates that concerns over the net foreign assets position of the United States is exaggerated, and may, in fact, be entirely misplaced. Indeed, there is enough evidence to suggest that the U.S. may not be a net international debtor at all. But even accepting the current figures, it can be shown that the circumstances surrounding the United States are far removed from those of the problem debtors.

Debtor or Creditor?

It has been widely debated whether the following statements are true or false: The United States now far outdistances Brazil as the world's largest debtor nation, and the

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United States now rivals Japan as the world's largest creditor nation. Depending on how one looks at the data, the answer to both questions is true–a logical impossibility. An examination of the data proves why that is so.

According to official data from the Department of Commerce, at the end of 1986, the U.S. had a net international debt of $263 billion, compared to Brazil's debt of $110 billion. But comparing the U.S. debt to that of Brazil, or any other problem debtor, is like comparing apples to oranges. For example, the debt of the LDCs, as it is now computed, only includes financial borrowings from foreign banks, governments and multilateral agencies, net of official foreign reserves. In contrast, America's debt, as it is computed and reported, also includes net foreign direct investment and private assets.

In addition, direct investment by American companies abroad and by foreigners in America are recorded at book value. Yet, the average age of the U.S. stock of direct investment abroad is much older than foreigners' investment in the U.S. This means that if direct investments were revalued at current market prices, the value of U.S. investments abroad would rise by much more than the value of foreigners' investments in the U.S. As a result, the net foreign position of the U.S. would improve drastically. Furthermore, U.S. gold reserves are still valued at $42.22 an ounce. If America's 262 million ounces of gold were valued at today's market value, U.S. assets would be boosted by about $100 billion. Jason Benderly of Goldman Sachs, estimates that if America's assets and liabilities were valued correctly, at the end of 1986 the U.S. had net foreign assets of approximately $200 billion. This figure is roughly equivalent to Japan's, supposedly the world's largest creditor nation. 1

Comparing Apples and Oranges

In addition to the doubtful nature of the data for the U.S. international debt, there are even more important reasons why the parallel with the current plight of the indebted LDCs is inappropriate. In 1986, the net international debt position of the United States amounted to 6.3 percent of GNP. That does not even begin to compare with the problem debtors whose external debt, according to the International Monetary Fund, averaged 54.8 percent of their GDP.

A more important distinction, however, is the use to which the borrowed funds are put. The problem debtors are in their current situation because much of the funds borrowed from abroad were used to finance current consumption and at times, capital flight. Despite claims to the contrary by some analysts, including the Joint Economic Committee staff, that is not the case in the U.S.

A recent Joint Economic Committee study claims that "the U.S. net debt...largely reflects a higher rate of consumption in the United States...rather than increased investment." This assertion stems from the fact that only 28 percent of the foreign assets in the U.S. are in direct and equity investment. The argument continues to claim that the U.S. government consumes too much, thus absorbing private savings. Hence, foreigners must invest more in the U.S. than Americans invest abroad in order to finance this "excess government consumption." 2

But contrary to the widespread claims of a U.S. consumer binge, private consumption has increased only at average rates during the current expansion (20.5

percent compared to 21.1 percent during the 1975-79 recovery). The same is true of investment in producers' durable equipment (43.6 percent increase since the recovery began, compared to 41.9 percent in the 1975-79 period). Imports are the only sector experiencing a faster than average growth rate during the current cycle. But the increase has not been dramatically faster–a 54.8 percent increase since the end of the recession, compared to 48.4 percent in the 1975-79 recovery.

The key to the argument is not private but public consumption. Government spending has, in fact, increased very rapidly as evidenced by the budget deficit. However, this argument assumes that the U.S. government does not invest. But as economist Alan Reynolds has shown, the U.S. government invests in infrastructure such as highways, schools, dams, subways, airports, etc. The government also uses capital equipment such as fire engines, police cars and computers. It is therefore, wrong to assume that all government spending is consumption. This confusion can be attributed to the fact that the U.S. is the only industrial nation that does not separate public investment from public consumption in its official data.

Given that the U.S. government invests as well as it consumes, it cannot be said that the debt incurred has been for "nonproductive purposes." To the contrary, the yield from most government investment is "a healthier, more educated labor force, greater security of property rights, a better transportation network..." 3 Such investments raise the economy's output and income, and this in turn, allows for the servicing of the debt.

What do the Numbers Really Show?

Nevertheless, we can only debate this issue on the basis of the officially available data. Keeping these two caveats in mind: That the figures may be significantly overstating the actual situation, and that there is no basis of comparison with the indebted LDCs, an examination of the factors that contributed to the ballooning of the measured foreign debt is necessary.

The bulk of foreign direct investment in the United States is in the hands of West Europeans. Traditionally, European investment in the U.S. has accounted for two-thirds of total FDI and has been concentrated in manufacturing industries. That relationship has changed only slightly. For example, out of a total of $24.7 billion in new FDI in 1986, Western Europeans held $17.2 billion, or 69.6 percent. Japanese investment, on the other hand, increased by $5.1 billion in 1986, accounting for 20.6 percent of the total increase. Contrary to the popular notion, Japanese investment is not confined to auto manufacturing but is concentrated in the financial and wholesale (service) sectors. Finally, the Latin American and Middle Eastern countries both reduced their investments in the U.S. last year.

Manufacturing investments continue to dominate the attention of foreign investors, followed by the petroleum and insurance sectors. Foreign investments have also grown in commercial real estate. Foreign investors now own 46 percent of the commercial real estate of downtown Los Angeles, 39 percent of Houston, 32 percent of Minneapolis and 21 percent of Manhattan. The British (who burned Washington in 1814), have now built or bought an estimated $1 billion in the District of Columbia. And Japanese investors recently bought the Exxon headquarters building in Manhattan for $610 million, the highest price ever paid for a skyscraper.

Esteemed U.S. corporate nameplates are also changing hands. Doubleday books has gone to the West Germans; Brooks Brothers clothiers to the Canadians; Smith & Wesson handguns to the British; General Electric television sets have been bought by the French; Carnation Foods by the Swiss; and General tires by the West Germans.

This "foreign investment wave" has indeed become controversial. But has there really been a dramatic change in FDI? The answer, as Table 1 makes clear, is no. Foreign direct investment in the U.S. has changed relatively little since 1980. With the exception of 1982 and 1983 when the recession and its aftermath reduced the attractiveness of investing in the U.S., the annual increase in foreign investment has hovered around $25 billion. Foreign investment in the U.S. rebounded strongly in 1984 but the post-recession average remains below the 1980-1981 average.

TABLE 1

CHANGE IN FOREIGN DIRECT INVESTMENT
1980-1986

[Increase (decrease) from previous year in billions of dollars]

	1980	1981	1982	1983	1984	1985	1986
U.S. Investment Abroad	27.6	12.9	-20.5	-0.6	4.3	18.3	30.1
Foreign Investment in U.S.	28.5	25.7	16.0	12.4	27.5	20.0	24.7

Source: U.S. Department of Commerce.

It is U.S. direct investment overseas (not FDI in the U.S.), that explains the shift in the net investment position of the United States. American investment abroad declined sharply in 1982 and 1983 and, although it has recovered since then, the average change in U.S. investment abroad during the past three years remains significantly below the 1980-1981 average. The reason for this is the relative attractiveness of investment in the United States. In particular, the decline in U.S. marginal tax rates placed the U.S. at a comparative advantage over other industrial countries.

Once the final phase of tax reform goes into effect, the U.S. will have the lowest top marginal tax rate on personal income of any OECD country. Despite the fact that other industrial nations (including Japan and Germany), have proposed reductions in their top marginal tax rates, the U.S. tax rate will remain the lowest. Moreover, no other OECD nation can match the magnitude of the U.S. decline in the top tax rate.

The significance of the lower tax rate is that it creates an economic environment conducive to growth and investment. Numerous studies show that the countries with higher tax rates had very weak investment growth. For instance, the U.S. with a marginal tax rate of 42.6 percent in 1983 experienced a 5 percent growth in capital formation during 1980-85. At the other extreme, Belgium, with a marginal tax rate in 1983 of 61.7 percent experienced a 4 percent decrease in capital formation during that same period. 4

It is important to remember that foreign investment creates new jobs. Foreign investment is directly responsible for nearly 3 million jobs in the U.S., roughly equal to the total civilian work force of Massachusetts or Virginia. Increased productivity also results from increased investment in more and better machinery and equipment. Over $63,000 worth of buildings and equipment are required to employ the average worker in the private sector. Moreover, foreign funds are an important source of venture capital. Of the $2.3 billion in venture capital funds raised last year, nearly 25 percent came from overseas. These investors are not so much interested in the promise of financial gain as they are in the wealth of new technology they hope to develop.

There is nothing intrinsically wrong with importing capital, particularly when it is used to finance productive investment. The data show that the largest increases in foreign assets in the U.S. take the form of direct investment and equity investment. The U.S. has enjoyed far more rapid economic growth than would have been possible without foreign investment. In 1986, for example, U.S. individuals and corporations saved $680 billion and the government borrowed $143 billion to finance the budget deficit. If there had been no foreign capital inflow, private investment in the U.S. could not have exceeded $537 billion.

Other Contributing Factors

Another contributing factor to the decline in U.S. investment abroad was the LDC debt crisis, which not only affected U.S. direct investment in those countries but also bank claims. As U.S. banks virtually stopped lending to the problem debtors, U.S. bank claims fell dramatically. In 1982, U.S. lending to problem debtors collapsed. After increasing by $111.1 billion in 1982, claims reported by U.S. banks increased by only $1.8 billion in 1985. While bank claims recovered in 1986, the increase ($59 billion) remains well below the 1981 and 1982 levels.

TABLE 2

CHANGE IN U.S. CLAIMS REPORTED BY U.S. BANKS
(increase from previous year in billions of dollars)

1980	1981	1982	1983	1984	1985	1986
46.9	89.6	111.1	29.2	11.1	1.8	59.0

Source: U.S. Department of Commerce.

The surge in the U.S. stock market also played a role in the shift in the U.S. net foreign assets position. Foreign holdings of U.S. stocks increased dramatically in 1985 and 1986, reflecting rising corporate profits, low inflation and falling interest rates (see Table 3).

TABLE 3

CHANGE IN EQUITY INVESTMENT
(increase from previous year in billions of dollars)

	1980	1981	1982	1983	1984	1985	1986
U.S. Purchase of Foreign Securities	5.9	0.7	12.1	8.3	5.3	23.7	18.2
Foreign Purchases of U.S. Securities	15.5	1.0	17.9	20.7	13.6	79.3	102.9

Source: U.S. Department of Commerce.

A recent study by the Joint Economic Committee concludes that extremely tight monetary policy drove up interest rates in the U.S., thereby creating a very strong foreign demand for dollar-denominated assets. The resulting surge in the value of the dollar, combined with strong growth in domestic demand stimulated by large federal budget deficits, led to a sharp loss of U.S. competitiveness and drove the trade and current account deficits to unprecedented levels. The JEC concludes that the problems created by fiscal and monetary policies were aggravated by the inability of the U.S. to persuade the major industrial nations to grow more rapidly, the failure to develop a strategy for economic growth in the debtor nations, and significant neglect of problems of productivity and competitiveness in American industry. 5

The data, however, paints a different picture. Foreign holdings of U.S. Treasury securities surged in 1984 and 1985, but this represented a relatively small proportion of total foreign assets in the U.S. and the trend appears to have reversed itself in 1986. After rising by 72 percent in 1984 and 44 percent in 1985, foreign holdings of U.S. Treasury securities rose by only 15 percent last year. As a result, they are now 7.2 percent of total foreign assets in the U.S., down from almost 8 percent in 1985.

TABLE 4

FOREIGN HOLDINGS OF U.S. TREASURY SECURITIES
(increase from previous year)

	1980	1981	1982	1983	1984	1985	1986
$ Billions	1.9	2.4	7.3	8.1	24.3	25.4	12.4
Percent change	13.4	14.8	39.2	31.4	71.9	43.7	14.7
As percent of total	3.2	3.2	3.7	4.3	6.5	7.9	7.2

Source: *Survey of Current Business*, June 1987.

A major reason for the continuing demand for dollar-denominated assets is that the U.S. offers the best return on foreigners' investments. The fact that a large number of foreigners are investing in the U.S., rather than in their own countries, is a tribute to the strength of our economy as well as a warning about the weakness of a number of foreign economies. In general, the U.S. continues to be the only engine of growth in the world.

Conclusion

The concern over the likely consequences of the large international debt of the United States is overstated. And, inasmuch as the shifts in FDI, U.S. bank claims, foreign holdings of securities and other components of U.S. financial transactions, are the result of positive forces in the U.S. (higher real after-tax returns on investment, lower investment risk) and negative forces abroad (lackluster growth of most major foreign economies, high risks of default, nationalization or war in the LDCs), the appropriate U.S. response should be to encourage the same salutary environment elsewhere, not to infect the U.S. economy with the cancers that are sapping the strength of foreign economies.

Unfortunately, there is legislation being considered in Congress which will do just that. The House trade bill includes a provision known as the Bryant Amendment, which would require foreign investors to register and report information concerning their U.S. operations for public disclosure. This applies to both privately and publicly held companies. This proposal is not only discriminatory, it is redundant. This nation already has a number of statutes on the books which provide for the collection of information about foreign investors as well as regulate various industries on an ongoing basis. The enactment of the Bryant Amendment will only serve to discourage further FDI. American legislators would do well to remember that after several decades of experimenting with different development strategies, it is now abundantly clear that the nations that prospered were those that welcomed foreign capital and technology. The nations that failed are those that attempted to prosper behind high tariff walls, closing themselves off to foreigners in a vain effort at becoming self-sufficient in an increasingly interdependent world economy.

The challenge facing today's policymakers is maintaining the U.S. economy on a steady growth path. As long as the notion that the U.S. foreign debt rivals Brazil's continues to be believed, the risk of enacting Brazil's solutions could occur. Recall that Brazil did turn its trade deficit into a surplus in 1985 in order to pay its external debt. But the cost was a painful recession. A recession will slash domestic demand for imports and in the process, impoverish our trading partners and reduce their interest or ability in investing in the U.S. That's an irresponsible solution to a problem that may not even exist.

* * * *

Footnotes

[1] "Well, would you debit it?" *The Economist* (London: The Economist Newspapers, Ltd., August 1, 1987) p. 73.

[2] Joint Economic Committee, "The Economy at Midyear: A Legacy of Debt," August 1987.

[3] Alan Reynolds, "Public Investment, Not a Binge," *The Wall Street Journal,* July 27, 1987.

[4] Alan Reynolds, "The Investment Opportunity Theory of Capital and Trade Flows," (Morristown, New Jersey: Polyconomics, Inc., May 27, 1987) p. 6.

[5] Joint Economic Committee, op. cit.

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U.S. Chamber of Commerce Economic Policy Division

Policy Working Papers

April 1988 *Number 14*

THE DECEPTION OF POLITICAL "ARITHMETIC"

by
Lawrence A. Hunter
Deputy Chief Economist

"In political arithmetic, two and two do not always make four." This aphorism is as true today as 200 years ago when first penned by Alexander Hamilton. It may be even more accurate now, since political addition and subtraction often produce results opposite even from the "new math" taught in today's schools.

In the wake of last October's stock market crash, congressional leaders and the Reagan administration negotiated a budget compromise to reassure the world that Washington could manage the nation's fiscal affairs. Congress and the president claimed the pact would "cut" the federal budget deficit by $76 billion over the next two years, reducing it by $30 billion in 1988 and $46 billion in 1989.

Yet, the president's own fiscal year 1989 budget projects a 1988 deficit that is $3.7 billion lower than 1987's deficit of $150.4 billion. And, in 1989, the projected deficit is only about $17 billion lower than in 1988. Old fashioned arithmetic totes up the savings at less than $21 billion over two years, or $55 billion less than advertised.

Using Congressional Budget Office figures, the outcome of last year's exercise is even more paradoxical. CBO estimates that the 1989 deficit will equal $165 billion, or almost $15 billion more than last year. If CBO is correct, Congress and the president, like Alice, have stepped through the looking glass into Budgetland. There they have found they must raise taxes more and more to keep the deficit from growing–a race we appear to be losing.

How can this be? The key to understanding is to use political arithmetic, a branch of mathematics closely akin to the algebra of the used car lot. As anyone who has attempted to buy a used car knows, we are told we will "save" more by stepping up to

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a Cadillac rather than simply replacing our old worn out Chevrolet with a new one. Why? Because as a buyer negotiates, the salesman will "cut" the price of the expensive car more than the cheaper car. The buyer then proudly points to his "savings," masking the higher price he ended up paying. Such a deal!

The bipartisan budget compromise exemplifies the same kind of logic. Rather than comparing this year's and next year's estimated budget deficits, Congress prefers comparing the 1988 deficit to what the 1989 deficit would have been without the budget agreement. So, when it claimed to "cut" the deficit by $76 billion, Congress really meant that the deficit would be $76 billion lower than projected estimates before the compromise. So much for the heroic "deficit reduction package." One trembles to imagine the effects of political cowardice if this is heroism.

Practitioners of political arithmetic, such as House Speaker Jim Wright, want us to believe the budget deficit is the fault of the "massive tax cuts" supported by President Reagan. Wright has said we cannot balance the budget if we go on "reducing our revenues by $135 billion per year." Once the essentials of political arithmetic are understood, it is easy to see through this argument.

While marginal tax rates have been lowered, tax revenues have grown since 1980. After adjustment for inflation, federal receipts have risen by roughly 2.8 percent a year, the same rate as the economy. In 1987, revenues totaled 19.4 percent of GNP, the exact same share of GNP taken in taxes by the federal government in 1980. It would seem that Wright's comment about a loss in revenues is really a complaint that Congress has not allowed taxes to continue growing at the 1980 rate–roughly 17 percent.

Federal spending on the other hand, has almost doubled since 1980, growing from $591 billion to more than $1 trillion last year. In inflation-adjusted dollars, real federal spending has increased at an average rate of 3.3 percent a year since 1980. Compare this to a 3.7 percent average annual rate of increase between 1970 and 1980. Congress has not cut spending. It merely has reduced the rate of growth in spending by a paltry 0.4 percent.

The source of the deficit is to be found in the different rates of growth between spending and tax revenues. Since taxes continue to absorb exactly the same share of GNP as they did before the deficit exploded, it should be obvious that the increased rate of federal spending is out of line and is responsible for the deficit. Blaming the deficit on insufficient tax revenues is like accusing the Red Queen of loafing in her race to keep up in Wonderland.

Last year's episode of "Congress In Budgetland" saw taxes raised by $29 billion over two years. These are real taxes computed by real, not political, arithmetic. Real arithmetic also tells us that in 1989 the deficit will be reduced by $21 billion from it's 1987 level. Old fashioned subtraction reveals that $8 billion of that tax increase is not going toward deficit reduction. Put another way, only about 72 cents of every dollar of increased revenues from the budget compromise will go toward deficit reduction.

Where did the other 28 cents go? Think of it as political profit, a 28-cent commission "earned" by Congress on the sale of the bipartisan deficit reduction package to the American public. Of course, the $8 billion was not divided equally into 535 payments for each member of Congress. That would be old fashioned graft. Instead, the commission was taken in the form of political currency–increased public spending conferred strategically on selected segments of the electorate. And, that currency was calculated to buy votes to help keep each member safely ensconced in office. The overall rate of re-election in the Congress currently stands at about 90 percent.

As the bipartisan budget compromise illustrates, even when a perceived crisis of confidence requires Congress and the president to take dramatic action, Congress still insists on its commission and on spending part of the tax increase. Therefore, it should not be surprising to discover that during more normal times, Congress has been even more profligate. For every $1.00 increase in receipts between 1980 and 1987, Congress spent $1.41. (If one accepts CBO estimates, the crisis-induced 1987 budget agreement will produce a rise in spending of $1.51 for every $1.00 of additional revenues.) Using this rule of thumb, a tax increase equal in size to the 1989 deficit would lead not to a balanced budget but to a rise in spending of about $183 billion and an even larger deficit. In the words of the popular country western song, "One step forward and two steps back/Ain't gonna get too far like that."

The solution to balancing the budget is straightforward. It should not involve any kind of tax increase. Freeze aggregate spending for a period of two years and the budget will be balanced. An alternative would be the "Two Percent Solution," a reduction in the growth rate of federal spending just enough to bring it into line with the long run growth rate of the economy and federal tax revenues. By holding the annual increase in federal expenditures to 2 percent, the budget would come into balance in 1994 based upon current Office of Management and Budget estimates.

This is responsible fiscal arithmetic, not the convoluted logic of Congress In Budgetland. Until Congress is willing to put aside political arithmetic in order to solve America's deficit problem, its budgets will continue to rival the nonsense of Lewis Carroll–only without the humor.

5/18/88

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Economic Policy Division

Policy Working Papers

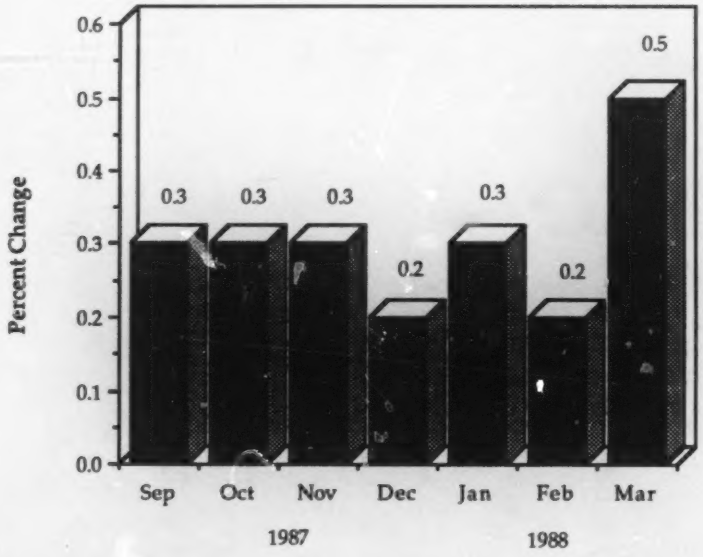
April 1988 *Number 15*

INFLATION: THE UNTOLD STORY

by
Graciela Testa-Ortiz
Director, Forecasting Section

Last week's release of the consumer price index (CPI) for March has revived the nation's collective inflation phobia. The 0.5 percent March increase was largely due to a record jump in apparel and increases in food and housing prices. The following graph, showing monthly increases in the consumer price index, was reproduced in every major newspaper last week. It depicts in vivid terms the basis for current concerns over a resurgence in inflation.

Monthly Increase in Consumer Prices



This chart, however, is misleading. It does not tell the whole inflation story. With the release of March data, we now have inflation figures for the first quarter of 1988.

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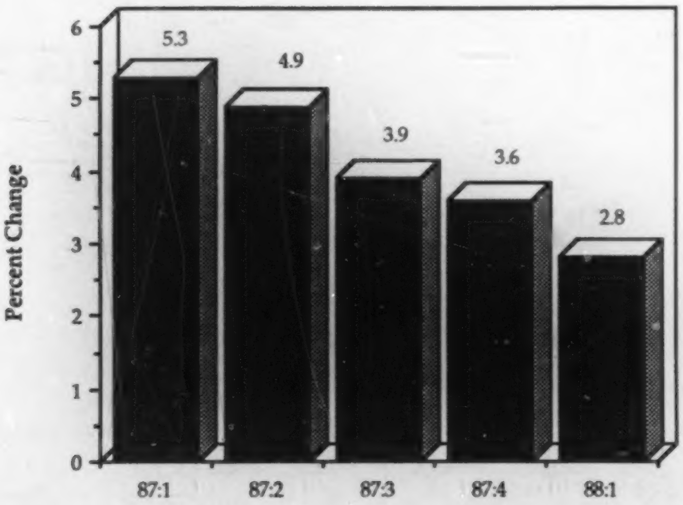
When the quarterly data are plotted, the real inflation trend is revealed, and it is starkly different than the one portrayed in the media last week. What we see is not a sharp acceleration in inflation, but the fourth consecutive quarter of *declining* inflationary pressures.

Quarterly Growth in Consumer Prices

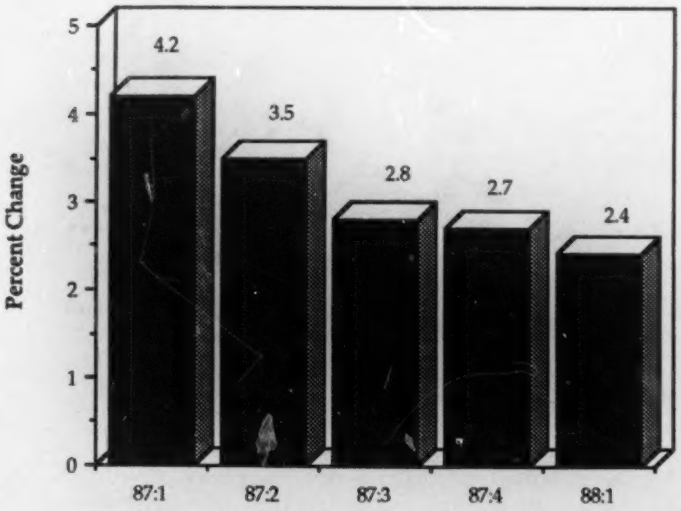
(Seasonally Adjusted Annual Rate)



This trend is consistent with the declining ratcheting down of inflation we have been experiencing since 1980. These numbers are not a fluke or a statistical construct; the decline in inflationary pressures as measured by the CPI is corroborated by the implicit deflator for gross national product (GNP), a broader measure of inflation. As demonstrated in the chart below, the GNP deflator paints the same picture of steady declines.

Implicit GNP Deflator

(Seasonally Adjusted Annual Rate)

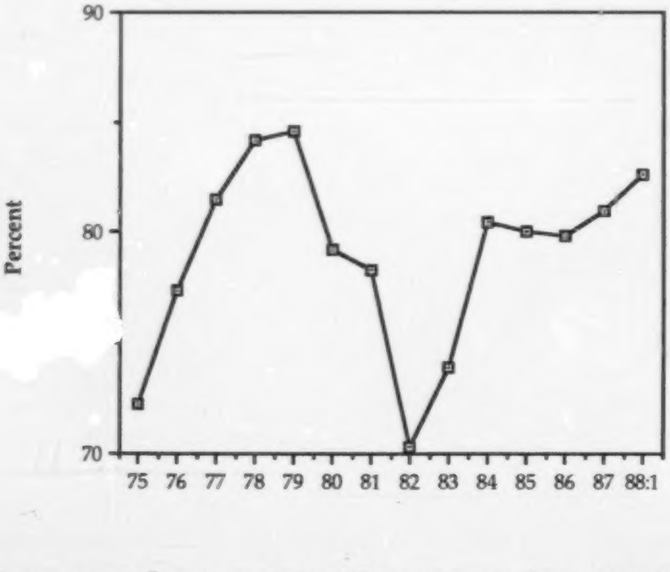


This, of course, is not the first time that the inflation alarm has been sounded during the course of our 66-month economic expansion. It seems that whenever the economy shows a bit more strength than had been anticipated, the inflation monster is revived.

Why do economic analysts posit that economic growth is inflationary? In short, it is assumed that there are "limits to growth," that is, as production increases, firms and industries will reach the limits of their productive capacity, bottlenecks and shortages will arise, and inflation will begin to heat up. These same so-called "limits" apply to the labor markets. The argument there is that continued improvements in the unemployment rate and demographic shifts could spell a resurgence in wage pressures. In addition, there are other developments that set off inflation alarms, including the fears of a possible resurgence in oil prices, the lagged effect of the decline in the value of the dollar, and increases in commodity prices.

An examination of these factors, however, shows that inflation fears based on them are exaggerated. The following chart shows the capacity utilization rate in manufacturing. After rising sharply from the depths of the 1981-82 recession, operating rates stagnated for most of 1985 and 1986 and began to trend up again in 1987. Yet, at 82.6 percent for the first quarter of this year, operating rates in manufacturing are well below the previous peak of 87.7 percent (in 1973). In addition, this view assumes that plant capacity is a given which cannot be changed. The truth is that American firms have been expanding their capacity to produce since the recovery began. Investment in producers' durable equipment, for instance, has risen by 17.9 percent from the first quarter of last year.

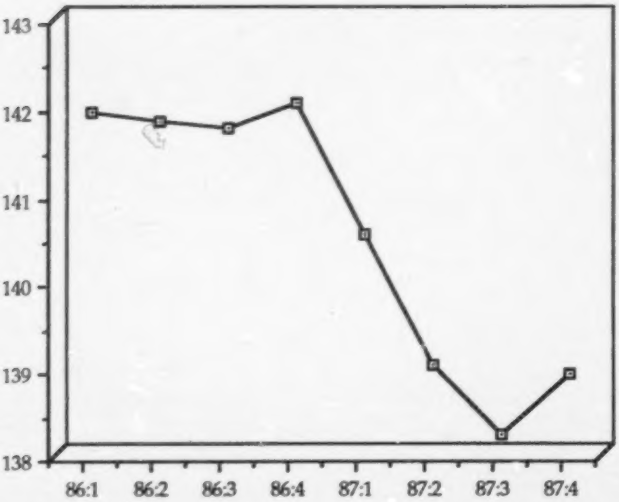
Capacity Utilization in Manufacturing



In the U.S. economy, employee compensation accounts for approximately two-thirds of national income, and is, therefore, a major component of business costs. Moderate wage pressures during the past several years are, therefore, counted among the reasons why inflation has subsided. Clearly, one of the reasons why wage pressures remained moderate was the high degree of foreign and domestic competition in labor markets. The concern at this juncture is that as the economy continues to grow, the demand for labor in some industries and regions has begun to rise faster than the supply, leading to an increase in wages and salaries. This concern is reflected nationwide in the fact that the unemployment rate is at a decade low of 5.6 percent. Yet, while the economy continues to create new jobs and the unemployment rate has declined steadily, labor productivity (output per hour) has also risen, due primarily to increases in investment. In the manufacturing sector, productivity rose by 3.7 percent in 1986 and 3.3 percent in 1987. As a result, unit labor costs have actually *declined*–by 0.4 percent in 1986 and 1.9 percent in 1987.

Unit Labor Costs in Manufacturing

(Index 1977=100)



The sharp drop in oil prices during 1986 was an important factor behind the deceleration in consumer price inflation during that year. Analysts point to the fact that steady oil prices during 1987 contributed to the 1987 rebound in inflation. Some analysts fear that renewed fighting in the Persian Gulf will result in higher oil prices. The opposite case, i.e., a lower oil price scenario, is just as likely, however. The fact of the oil situation is that OPEC has been unable to enforce production quotas for several years. Despite the fact that some non-OPEC producers have also shown an interest in curtailing production to support prices, the reality of the oil picture is one of plentiful supplies. Moreover, even in the face of an expanding world economy, consumption has not increased as rapidly as OPEC would like. In the meantime, many of the oil-producing countries have enormous debt burdens; they cannot afford to curtail production to prop up prices but must produce and sell to service their debts.

One of the most troubling prospects in the gloomy scenario on inflation is the lagged effect of the declining dollar. The fear is that sooner or later the dollar's decline, which began in early 1985, will be reflected in a major increase in domestic inflation. So far, it appears that foreigners have sacrificed profit margins in order to maintain their U.S. market shares. That is, although the decline in the dollar's value has reduced their profits, they have generally refrained from raising the price of the products they sell in the United States. The assumption is that they may have exhausted their ability to continue to do this and will henceforth raise their prices. The fact that one of the major components of the March increase in inflation was apparel–a sector where imports play an important role–is offered as proof. But this reflects a relative price change, not an increase in overall inflation, as is explained below.

The evidence, therefore, seems to suggest that while we can expect further increases in inflation, it is unlikely that we are in for a replay of the 1970s experience. Indeed, few analysts expect inflation to rise faster than about 5 percent during the next two years. The consensus forecast calls for an increase of 3.9 percent in 1988 and 4.6 percent in 1989.

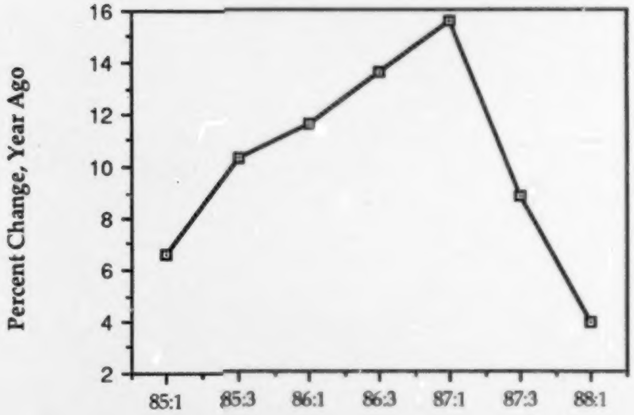
This analysis, however, is incomplete since it simply tells us that when prices increase we have inflation: a tautology. There are several points missing in this analysis. The first one is that economic growth *per se* is not inflationary. The supply and demand conditions just described presage moderate changes in *relative* prices; however, they are not necessarily an indication of future changes in the *overall* level of prices.

Inflation is a monetary phenomenon. At the micro level, a variety of factors affecting the cost and relative demand structures in individual markets can cause relative prices to change. For instance, a large increase in prices for imported goods, can cause large changes in the value of the consumer price index, as we saw in March. However, individual prices changing in relation to one another result, not in an increase in the overall price level, but in a reallocation of demand across markets. It is, therefore, incorrect to say that increases in the price of imports *cause* inflation.

The necessary condition in the inflation scenario is that there be no change in total spending or income beyond the capacity of the economy to produce. As long as changes in income remain within the productive capacity of the economy, the factors mentioned above cannot cause all prices to rise. It is the accommodating increases in the supply of money which, by raising the level of demand, removes the constraint on total spending and leads to a rise in the overall price level.

There is reason to be concerned about future inflation trends. It is the rapid increase in the money supply between the middle of 1985 and early 1987, which after a lag estimated at 12 to 24 months, will begin to have an impact on the rate of inflation. It is revealing to note that producer prices stopped declining in the second quarter of 1987, eight quarters (24 months) following a sharp and continued increase in the money supply. This accommodating increase in the money supply makes it possible for the emerging pressures on individual prices to be translated into increased inflation.

Increase in the Money Supply (M1)



Inflation watchers should be relieved to see the protracted tightening of money supply growth by the Federal Reserve. During the past three quarters, money supply growth has decelerated sharply. However, a moderate rate of money growth is a necessary but not a sufficient condition for a healthy economy: the money supply must also grow in a stable fashion. If this does not happen, we run the risk of being caught in a vicious circle where clamping down on the money supply reduces inflationary pressures and precipitates a downturn in economic activity. After a while, the lost jobs and production will increase the calls for an easing of monetary growth to allow for faster growth, completing the circle and increasing inflationary pressures again.

It is not slow economic growth that cures inflation, nor rapid growth that causes it. (Recall that the 1960s were characterized by rapid growth and low inflation while during the 1970s, we experienced slow growth and soaring inflation.) Rather, it is the rapid increase in the money supply that causes inflation to rise, and its volatility which thwarts growth.

In sum, it appears that the national economy has enough momentum to continue to grow with a declining rate of inflation. Whether or not the economy is able to maintain a path of stable growth depends upon the actions of the Federal Reserve. If the Fed overreacts to the monthly statistics, it can slow the economy significantly. As long as it continues to attempt to fine-tune the economy, the swings in the money supply are also likely to continue, as the Fed finds itself constantly reacting to the effects of its own past policies.

In the absence of clearly stated policy by the Fed, the financial markets pay undue attention to monthly inflation, employment and production data not in an attempt to discern trends in the economy, but in an attempt to discern what the Fed is likely to do next. The Fed would reduce financial market uncertainty if, immediately after each open market committee meeting, they announced their policy decisions and described how they intend to carry out the agreed upon policy.

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U.S. Chamber of Commerce Economic Policy Division

Policy Working Papers

May 1988 *Number 16*

TREASURY REPORT VINDICATES 1981 TAX CUT

by Richard W. Rahn
Vice President and Chief Economist

The numbers are now in and they show that the Reagan administration's tax policies have produced a more progressive tax system. The fact is that the rich are now paying a much higher percentage of the overall tax burden than in 1980, according to a Treasury Department report on 1986 individual income tax data. And this was achieved in a manner that promoted, rather than retarded, economic growth, job creation and prosperity.

I still remember the hoots of derision when supporters of the Economic Recovery Tax Act of 1981 asserted that lowering the top income tax rate from 70 percent to 50 percent would increase both revenues and the share of the tax burden borne by upper-income taxpayers. Opponents vigorously disputed these claims.

Tax reformers then argued that tax rates were so high that they were actually costing the government revenue. By lowering the rates, workers would be provided with an incentive to earn more taxable income. This, in turn, would supply the government with increased revenues. Supporters gave four primary reasons for this:

- A lower tax rate would make ordinary taxable investment more attractive than tax shelters.
- By reducing the tax on employment income, lower tax rates would provide an incentive for taxpayers to do more productive work.
- The 1981 tax law would make investment more appealing by raising the after-tax return on investment.
- The 1981 reduction in the capital gains tax rate from 28 percent to 20 percent would reduce the tax cost of selling capital assets. Consequently, investors

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would be inclined to realize their capital gains more often and the government would benefit from the higher tax revenues.

The official Internal Revenue Service statistics reveal that the supporters of the 1981 tax cut were absolutely correct.

Between 1981 and 1986, the share of the total tax burden borne by the top one percent of American workers increased from 18.1 percent to 26.1 percent. And the portion carried by those earning more than $100,000 increased from 15.2 percent to 30.6 percent. In contrast, the bottom half of American taxpayers, the lowest 50 percent, paid only 6.4 percent of all taxes in 1986 compared to 7.5 percent in 1981. Those workers earning less than $50,000 paid 66.8 percent of all taxes in 1981 but only 45.7 percent in 1986.

Equally as impressive, the government collected almost three times more tax revenue from the affluent after their tax rates dropped. Taxes paid by those earning more than $100,000 increased from $43 billion to $115 billion during the 1981 to 1986 period.

The 1986 tax reform act continued the policy of reducing marginal tax rates. In spite of the act's many shortcomings, it reduced marginal tax rates on most income and cut the top tax rate to 33 percent beginning in January 1988.

These rate reductions will have a similar impact to those of 1981. Lower rates, combined with the tax shelter limitations in the 1986 act, will increase the actual taxes collected from upper income individuals dramatically. However, the increase in the capital gains tax rate from 20 percent to 33 percent beginning in 1988 may outweigh the benefit of lower tax rates on ordinary income.

Unfortunately, increasing the capital gains tax rate by 65 percent is bound to cost the government revenue and have a detrimental impact on venture capital formation and overall economic growth. Such increases in tax rates also tend to reduce the share of the tax burden borne by the affluent.

In both 1978 and 1981, the capital gains rate was reduced and capital gains realizations increased more than enough to compensate the government for the lower rate. In fact, research by the U.S. Treasury Department and by Professor Lawrence Lindsey of Harvard University indicates that the rate which maximizes tax revenues on capital gains transactions is between 15 percent and 20 percent. That is why the president's tax reform proposal originally contained a 17.5 percent capital gains tax rate.

Objective observers of the data will conclude that lower marginal tax rates are the only reasonable policy. Only those who view economic success as something sordid, deserving punitive taxation, support high tax rates. Fortunately, most Americans do not want to punish economic success–particularly if it will cost the government revenue and slow the economy. In light of the evidence, lower taxes are the progressive policy option. And reducing the capital gains tax rates should be a priority for Congress.

Changes in the Distribution of Federal Individual Income Tax Payments 1981-1986

Shares of Tax Payments by Percentiles

Percentile	1981	1985	1986*	Percentage Change in Shares 1981-85	Percentage Change in Shares 1981-86*
Lowest 50%	7.5%	7.2%	6.4%	-4%	-15%
51 - 95%	57.6	52.9	49.3	-8	-14
95 - 99%	16.8	18.0	18.2	+7	+8
Top 1%	18.1	21.9	26.1	+21	+44

Shares of Tax Payments by Income Category

Adjusted Gross Income	1981 Taxes Paid#	1981 Share	1985 Taxes Paid#	1985 Share	1986 Taxes Paid#	1986 Share
Under $50,000	$189.9	66.8%	$170.6	52.4%	$172.4	45.7%
$50,000 - $100,000	51.1	18.0	77.9	23.9	89.1	23.7
Over $100,000	43.2	15.2	77.3	23.7	115.4	30.6

Key:
* Preliminary data
# Dollar amounts in billions

Source: U.S. Department of the Treasury, Office of Tax Analysis
Internal Revenue Service, Statistics of Income Division

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Economic Policy Division 8/88

Policy Working Papers

June 1988

Number 17

FACTS AND FALLACIES ABOUT FOREIGN INVESTMENT

by
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Many stories are being written stating that the U.S. has become a second-rate country, moving from the world's largest creditor nation to the largest debtor in a short span of time. There are claims that foreigners are "buying up America" and gaining control of our political institutions by financing federal debt and altering state and local policies.

Other stories extoll the virtues of foreign investment in the U.S. According to these views, the U. S. is not a debtor in any meaningful sense—we do not owe more than we are worth nor even more than we produce—and foreign investment, rather than being a serious burden, has been, in fact, a boon to our economy.

This paper presents the ideas behind the scare claims, the types of congressional responses we've observed in recent months, the data on foreign investment, and analyzes the competing views.

The Case Against Foreign Investment in the United States

Critics of foreign investment present a broad attack in newspaper and magazine articles, congressional testimony, and books. There are eight major arguments they make to support their view. Each will be mentioned and then analyzed in turn.

1. *We have become a debtor nation. Repaying this debt will cripple our economy.* The critics of foreign investment use the supposed debtor status to label the U.S. a second-rate country.

2. *Foreigners are buying up America.* The arguments focus on reports of Japanese purchases of urban land and other real estate, especially in Hawaii and the western U.S.

3. *The growing dependence on foreign investors makes our future uncertain.* Like the familiar concerns over energy dependence, the notion presumes that the U.S. will suffer because of alleged dependence.

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4. *Foreign investment is a threat to our national security.* Critics argue that foreigners will buy companies dealing in defense and other sensitive areas to learn our secrets.

5. *Foreign companies and governments are gaining dangerous political influence over state, local, and national policymaking.* For example, city officials are criticized for competing for foreign investors by offering deals on taxes and other "giveaways."

6. *Foreign companies operating in the U.S. offer only menial jobs to U.S. workers.* Critics point to assemblage jobs as typical of the work in U.S. affiliates.

7. *There is not enough control or scrutiny of foreign investors.* In the 1988 trade bill debate, the so-called "Bryant Amendment" was aimed at greater scrutiny and control.

8. *Foreign investors produce here to avoid our tariffs and import quotas.* For example, Japanese automakers produce in the U.S. and their sales are not subtracted from import quotas.

Is the United States a Debtor Nation?

Near the middle of 1985, commentators began reporting that the U.S. had lost its status as the world's largest "creditor nation" and had become a "debtor nation." Utilizing historical data accumulated by the U.S. Department of Commerce, commentators asserted the U.S. became a debtor nation when the value of foreign held assets in the U.S. exceeded the value of U.S. assets held abroad.

Assertions of this sort, however, do not comport with accepted notions of what debtor status means. For example, a debtor can be construed as having negative net worth, owing more in liabilities than owning in assets. In the U.S., all assets—including corporate equity and bonds, government bonds, bills, and notes, real estate, wholly owned businesses, private wealth, bank assets, etc.—amount to about $30 trillion. U.S. net worth in 1987 exceeded $10 trillion. *And as of the end of 1987, total foreign holdings of U.S. assets amounted to approximately $1.5 trillion or about 5.6 percent of all U.S. assets.*

Another accepted way of looking at the burden of debt is to compare the amount of debt with a year's worth of income. U. S. GNP is approximately two and a half times the amount of foreign held assets in the U.S. That is, *U.S. income in one year is more than sufficient to completely buy out all foreign assets owners at once, a prospect no one seriously expects the nation to face.*

More realistically, only a small portion of U.S. GNP is required to satisfy foreign asset holders in the form of an annual rate of return. Whatever that amount must be, it will flow directly from private investments. All private investment in the U.S. is made on the basis of expected returns from that investment. Thus foreign asset holders are in the same position as U.S.. resident asset holders—their investments are the basis of future repayments.

In 1987, it was estimated that U.S. holders of foreign assets earned $6 billion more from these assets than did foreign holders of U.S. assets. *This suggests that the reported $1.1 trillion of foreign assets held by the U.S. were undervalued*—to be consistent with their higher income yield, foreign assets held by Americans should be valued above the $1.5 trillion held by foreigners.

There is reason to believe that this is the case. The reported book values represented historical costs. U.S. asset holdings were acquired earlier than foreign held assets in the U.S. This led one writer to conclude that the value of U.S. assets, when adjusted for changes in price levels, actually exceed the value of foreign held assets in the U.S. by $200 billion.

Consequently, the U.S. is in no meaningful sense in debtor status, with respect to its total assets and its ability to pay. Even by the questionable measure presented by the critics of foreign investment, the U.S. is not a "debtor nation" when the data are properly compiled.

It is also common sense that repaying foreign asset holders will not cripple the U.S. economy. The bulk of their assets in the U.S. generate their own return. These payments come from growth in the U.S. economy, growth that these foreign investments helped to generate.

Approximately $290 billion of the $1.5 trillion in U.S. assets held by foreigners is in the form of government securities. This represents 14.6 percent of total outstanding government debt, down from 1980 foreign holdings of 16.7 percent. This discredits the argument that foreigners are financing the U.S. government debt. If anything, foreigners have shifted from unproductive (for the U.S.) investment in bigger government into productive investment in the private sector. Repaying government debt, regardless of the holder of that debt, must come from general economic growth in the U.S.

What Motivates Foreign Investment?

Not only are the data poorly measured and their meaning misconstrued, but there is also fundamental ignorance of what motivates foreign investment. *Beginning in 1981, U.S. investment overseas dropped considerably, a drop that lasted until 1986. At the same time, total investment, including foreign investment, in the U.S. was increasing. It took off in 1985 with greatly increased purchases of U.S. corporate securities.*

The reason for the increase was the relative attractiveness of investment in the U.S. noticed first by U.S. investors who came "back to America" and later by foreign investors. The initial impetus in 1981 was a sharp rise in U.S. interest rates over those in other countries. Foreigners invested more heavily in debt instruments that payed dollars at a fixed rate because of a rising international value of the dollar, as well.

The second impetus was larger—the growth of the U.S. economy outstripped growth in the rest of the world since 1985. Accompanying this growth was a falling dollar which raised the attractiveness of equity investments to foreign investors.

It can hardly be said that the U.S. has become a second-rate nation similar to Brazil. The fundamental differences between the two countries are obvious. There is also a significant difference in the nature of each country's debt to foreigners. Brazil has borrowed from foreign banks to finance government programs aimed at development, and therefore, must repay its debt in other than its own currency. That is, to repay it's lenders, Brazil must earn dollars and other currencies through exporting.

The U.S., on the other hand, owes foreigners in its own currency, dollars. Dollars are earned from domestic economic activity as well as exports. Furthermore, *most of the U.S. repayment obligation is in the form of return on private investment. This "debt" to foreigners is no more "debt" than what American companies owe American investors.*

Neither U.S. taxpayers nor any other third parties "owe" foreigners for the risks of repayment they voluntarily accepted in purchasing private U.S. assets.

In summary, the U.S. is not a "debtor nation" by any commonly accepted standard. The measure that commentators use to make such charges are faulty and misleading. Repaying the bulk of foreign investment will be accomplished from our growth. And it is our growth which continues to spur increases in foreign investment in the U.S.

Are Foreigners Buying up America?

Recent reports of foreign investment in the U.S. tend to single out Japan as a big player in U.S. banking, hotels, urban real estate, and purchases of U.S. companies. However, Japan is a poor third to Great Britain and the Netherlands which are the largest investors in the U.S. Furthermore, as was mentioned above, *foreign investment of $1.5 trillion in the U.S. represents only 5.6 percent of total U.S. assets. Certainly foreigners as a whole, or any single country, including Japan, cannot be said to be buying up America to any significant degree.*

For the purposes of illustration, three major categories of assets can be analyzed—corporate equity, which includes direct foreign investment and holdings of corporate stock, private credit market debt, and U.S. government securities.

Foreign Holdings of Corporate Equity

As of the end of 1986, foreign direct investment in the U.S. totalled $209 billion. By definition, foreign direct investment represents foreign holdings of 10 percent or more in a U.S. company plus the total value of wholly owned foreign subsidiaries of foreign companies or, as they are called, U.S. affiliates. Of this total, Great Britain had $51.4 billion of direct investment, the Netherlands $42.9 billion, Japan $23.4 billion, Canada $18.3 billion, West Germany $17.4 billion, among the major foreign investors. Foreigners held an additional $310 billion in corporate stocks and bonds for a total investment in U.S. businesses of $519 billion. This represented only 4.1 percent of total U.S. private investment as of the end of 1986.

While the numbers are large (billions), the portion is small. The question is whether foreign purchases of U.S. assets are growing at an alarming rate. Between 1980 and 1986, foreign direct investment grew annually by an average of $21 billion. This translates into an annual compound rate of 10.3 percent for that period. Corporate stock purchases grew by an average of $17 billion per year, or an annual compound rate of 10.9 percent. However, in that same time span, 90 percent of the world's economic growth was concentrated in the U.S. Tax rates in the U. S. were reduced, making investment here more attractive relative to other countries. The value of corporate assets in the U.S. rose by over 12 percent per year.

Foreign investment in the U.S. has picked up since 1980, as well as U.S. investment in total. The percent of foreign holdings in U.S. businesses (4.1 percent) is almost the same as it was in 1980.

Foreign Holdings in U.S. Credit Markets

Looking at the private U.S. credit markets yields a similar story. Near the end of 1986, foreigners held $518 billion of private debt. This accounts for only 5.1 percent of total private credit, up about one percent from 3.9 percent in 1981. Again, this is a small portion of the total market and does not comport with a "buying up" of America scenario. Higher interest rates in the U.S. have attracted foreign funds to U.S. credit markets and have kept U.S. savings at home.

Near the end of 1987, foreigners held approximately $290 billion of the then almost $2 trillion government debt. Their holdings, as reported above, represented 14.6 percent of all holdings, but this was down from 16.7 percent in 1981.

The recent emphasis on new foreign holdings appears to exaggerate the reality of the situation. In no meaningful sense are foreigners buying up America. *And the focus on Japan appears to be motivated by something other than the numbers. Overall holdings of U.S. assets by European countries stood at $745 billion at the end of 1987. Japan held only $187 billion, overtaking Canada's position in third place in 1986.*

Is America Dependent Upon Foreign Capital?

Among the catch words to raise alarm about foreign investment in the U.S. is the alleged "dependence" of the U.S. on foreign investors. Some commentators have remarked that the presence of foreign investors makes our future dependent upon their actions. And they seem to be saying our future is less certain because we can't trust foreigners.

These arguments make no sense when we analyze from whence these funds come to the U.S. The U.S. is currently running a trade deficit with most industrialized countries. This means that the value of our imports exceed the value of our exports. We are thus supplying the rest of the world with more dollars than they need to purchase our exported goods and services.

Foreigners who earn dollars can hold or trade them. Whoever ends up holding U.S. dollars can only spend them in the U.S. or in other countries, like Panama, who will accept U.S. dollars. If foreigners don't use dollars to buy goods and services, they can deposit them, loan dollars in return for securities payable in dollars, or buy U.S. assets. Ultimately, virtually all the dollars that left the U.S. come back as consumption, saving, or investment. Thus, the U.S. benefits from its imports—both merchandise and investments.

The size of the trade deficit means that the flow of dollars back to the U.S. will also be large. If it comes back as added consumption, this helps our export industries. If it comes back as savings, this keeps interest rates here down and helps satisfy U.S. investors who are seeking funds to borrow. If it comes back as investment, this adds to our growth and raises the value of our assets.

Concern over what foreigners might do represents more of a concern as to what form the dollars will be used. For example, suppose the Federal Reserve (Fed) stopped maintaining such high interest rates in the U.S. by supplying more credit itself and thereby discouraging savings in the U.S. by foreigners. Foreigners with dollars would then shift toward more consumption or investment. At first, however, those who held dollars might try to sell them on international currency markets leading to a depreciation in the value of the dollar. Such a depreciation would make our exports look more attractive as well as our assets because foreigners would have to spend less of their own currency to purchase our goods and assets.

The concern over what foreigners will do with their dollars is probably more of a political concern rather than a real worry about the U.S. economy. If the Fed and the U.S. Treasury want to stabilize foreign exchange rates, they must realize that foreign holders of dollars (over whom they have little control) can thwart that policy. In fact, this is what we observe most of the time these days within policy circles. Maintaining the international value of the dollar requires more and more credit restrictions by the Fed when pressures for the dollar to depreciate become strong.

Thus to meet U.S. policy of stable exchange rates, we are in a sense dependent on the actions of foreign holders of dollars. But this is also true of any U.S. traders of foreign currencies whose activity in foreign exchange markets can affect the value of the dollar.

The problem may be with the adopted policy of attempting to engineer exchange rate stabilization, rather than letting the foreign exchange markets freely determine the value of the dollar. Maintaining the value of the dollar in the past year has placed, it is estimated, as much as 120 billion more dollars in the hands of foreign governments who have intervened to help support the dollar by purchasing them.

Instead of reducing the trade deficit by expanding exports and promoting growth in our economy which would, in turn, narrow the government budget deficit, foreign governments maintain the competitveness of their exports by buying dollars and using these dollars to purchase U.S. government securities. This has had the effect of thwarting improvements in our balance of trade. This is the prime reason for so much anguish about foreigners, including Japan, in the first place.

Discarding the policy of exchange rate stabilization would lessen the fear about the reactions of foreigners. It might also have a salutory effect on trade deficits and the government deficit as well.

Is Foreign Investment a Threat to our National Security?

Elliot Richardson considers the assertion that our national security is not safeguarded to be one of the key myths about foreign investment. In Senate testimony in March 1988, he points out that,

> like U. S. investors, foreigners must comply with all the laws on the books, the Securities and Exchange Commission reporting requirements, and antitrust laws. Then there are special restrictions for foreigners in certain key sectors such as radio and television, coastal and inland shipping, air transport and nuclear power. The Defense Department has a comprehensive set of regulations which limit or bar foreign ownership of companies that have government contracts involving classified information.

Thus, while foreign investors are treated like U.S. investors in general, they are proscribed from learning U.S. defense secrets. Operation control of the national security question is already in place involving several U.S. agencies who continually review applications of foreign investors. By using the national security scare argument, critics of foreign investment are trying to lure sympathy from those who place a high priority on our security.

Do Foreign Companies and Governments Influence Domestic Policy?

Critics of foreign investment consider the competition between states and local areas to attract investors to be damaging to our political process. They assert that governments at these levels engage in giveaways to attract foreign investors. They point to "deals" on roads, schooling, and taxes given to foreign investors as examples of how taxpayers subsidize foreign investment.

However, is this any different from treatment given to U.S. investors? Typically, local and state officials compete for investment with other states and localities. They offer incentives to invest in their area to spark economic growth and to increase their tax base. Comparable American investors receive the same treatment as the prospective foreign investor. By attracting sizeable investment, state and local officials expect to gain a larger tax base from the growth that springs from the investment.

At the national level, commentators have expressed concern over the large amount of dollars and U.S. government securities held by foreign governments. They claim that foreigners have a great deal of influence over monetary and fiscal policy since they may decide to sell those dollars and the securities they hold. This would cause a falling dollar and increases in U. S. interest rates.

Just the opposite impact on policy has occurred. *Foreign governments, at the behest of the U.S. government, have been acquiring dollars in the last year in large amounts to keep the value of the dollar up. Under agreements to stabilize the dollar, foreign governments have participated in promoting U.S. policy, not the contrary. They have used some of these dollars to buy U.S. securities also at the behest of our government thereby keeping interest rates down.*

Indeed, foreigners consider the dollar an international reserve currency. They have been concerned that U.S. fiscal policy has been over-stimulative and have lent their help in the only way they can to stabilize the dollar. Such reactions are hardly attempts to subvert U.S. economic policy objectives.

Do Foreign Companies Exploit U.S. Workers?

Commentators claim that U.S. affiliates offer assemblage jobs in the U.S. keeping the higher paying jobs at home. This represents an ironic reversal of the argument in the 1960s and 1970s, that U.S. investors were exploiting low wage foreign countries and exporting jobs from the U.S.

U.S. affiliates directly employ three million American workers and indirectly support millions more. They attract U.S. workers by offering work at the prevailing wages or better. Otherwise, they could not attract U.S. labor. While some of the jobs are assembly jobs, many are in the financial area and other service businesses. It is absurd to believe that U.S. workers are shortchanged or somehow exploited.

Is There Enough Scrutiny and Control of Foreign Investors?

Stricken from the omnibus 1988 trade bill was a provision, the so-called "Bryant Amendment", to require additional reporting and public disclosure by foreign investors. Critics of foreign investment supported this amendment to gain a purported improvement in knowledge about foreign investors. However, the requirements were onerous especially as ownership in a U.S. company increased to the point where disclosure would have shut off the flow of foreign investment to the U.S.

Furthermore, the U.S. Department of Commerce claimed that foreign investors were already carefully scrutinized and that public disclosure would greatly reduce the incentives to foreign investors to put their dollars back in the U.S.

One argument in support of the Bryant Amendment was since U.S. companies must reveal more detailed information in other countries that, in a retaliatory manner, we should require the same of foreign investors. Others, however, argued that critics of foreign investment are out to mimic the restrictions of other countries. To retaliate would be to do what they do, not what is right for America.

Does Foreign Investment Subvert our Tariffs and Import Quotas?

Critics of foreign investment claim that a major reason that foreigners produce here is to sell more products in America. U.S. affiliates can therefore avoid tariffs and import quotas on sales because their base of production is in the U.S. They argue that by selling more here, foreign investors thwart our policy of limiting their U.S. sales.

This argument is an extension of the protectionist sentiment that erected the import barriers in the first place. However, it loses some of its steam when applied to investment. One protectionist tenet is to protect American jobs. Yet foreign investment here adds American jobs.

Another aspect of this argument is that U.S. affiliates will tend to import more than do U.S. firms. This is indeed true. However, *U.S. affiliates account for more exports—roughly 26 percent of all U.S. exports. In the last six years, export growth of U.S. affiliates has far outstripped their import growth. Thus, trade by U.S. affiliates has on net reduced the U.S. trade deficit and added American jobs in direct accord with our stated policies.*

In Summary: The Case Against Foreign Investment

The arguments against foreign investment in the U.S. rely on misinformation, exaggeration and faulty analysis. What is left is traditional American fear of losing ground to outsiders, especially the Japanese.

Foreign investment in the U.S. is small compared to overall investment here. It does not subvert U.S. policy nor is there a threat to U.S. independence. The extent of investment in the U.S. is testimony to the strength of our economy and the stability of our business environment.

Protectionist sentiment appears to be a major motivating force behind the fears of foreign investment. Under this way of thinking, there must be something amiss, and they have searched for arguments to support their xenophobic suspicions. These arguments do not stand up under scrutiny. Protectionist ideas, in general, have never made any sense. But the suspicions don't seem to go away because of rational argument.

Foreign investment in the U.S. at least provides an opportunity to dispel some of the fears about foreigners by bringing them here to produce and to see first hand what foreign businesses can offer. It gives us a rare opportunity to bring to the U.S. new technology and management that may inspire future economic change for the better in this country.

The Benefits of Foreign Investment

Foreign claims on U.S. assets, including foreign direct investment, has resulted in more investment and savings in the U.S. Specifically, it has:

- Reduced interest rates in the U.S.
- Introduced new technology
- Expanded U.S. access to foreign markets through U.S. affiliates
- Added to our employment and growth

Conclusion

Capital flows into the U.S. are stimulated by prospects for high return here. U.S. dollars earned through our imports are a highly valued commodity internationally because they can be used to purchase U.S. products and buy U.S. assets. Restrictions on foreign investment would lower the value of the dollar internationally and the value of U.S. assets.

U.S. affiliates of foreign companies add to our trade balances by exporting more than they import. During the early 1980s when the dollar was valued much higher and interest rates made saving in the U.S. attractive, dollars flowed into bank accounts and credit markets. As the dollar fell, foreign investors shifted to real and corporate assets to attempt to capture the gain from U.S. growth. Thus, foreign investors have acted in concert with U.S. investors in the 1980s.

The largest foreign investors are important allies of the U.S. Restrictions on foreign investment would tend to threaten these strong relationships and heighten our concern over national security. The U.S. is still the world's largest investor in other countries despite obstacles to investment in other countries. This is because we, like foreign investors, desire to be closer to markets in order to serve those markets better.

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DO WE NEED A TAX INCREASE?

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EXECUTIVE SUMMARY

A growing conventional wisdom has it that the United States is so far in debt that a tax increase is required to head off rising interest rates and a capital formation crisis. This belief is accompanied by two other false assumptions: (1) the Reagan "tax cuts" were so deep that only draconian spending cuts could balance the budget without tax increases and (2) government spending should increase to fulfill "unmet needs."

This paper discusses each of these false assumptions and concludes that the federal budget can be balanced by 1993 without raising taxes while at the same time fully funding Social Security, paying all interest on the national debt and still increasing spending on all remaining programs at the rate of inflation.

How Large Is the Deficit?

Relative to the size of the nation's output, it is an exaggeration to characterize the federal budget deficit as massive. The federal budget deficit still equals 3.1 percent of GNP in 1988, but it is down from a high of 6.3 percent of GNP in 1983, and continues to decline. The total governmental sector deficit in the U.S. of 2.3 percent of GNP is now lower than the average total deficit among OECD countries (2.5 percent of GNP).

Does a Capital Formation Crisis Loom?

No capital formation crisis threatens. Private savings is substantially greater than the official statistics indicate and investment in the United States is surging ahead at a faster rate (an average annual rate of 6.6 percent in the 1983-1987 period) than in any other industrial country.

Despite the surge in investment since the end of the recession, capital formation is depressed by numerous distortive tax policies. Foremost among the burdensome taxes on investment is the capital gains tax, which was increased substantially in the 1986 Tax Reform Act. Congress could boost capital formation significantly by lowering the capital gains tax rate and removing other tax burdens on savings and investment enacted after 1981.

Will Tax Increases Reduce The Deficit, Lower Interest Rates and Increase Investment?

History demonstrates that a substantial portion of any tax increase will be diverted from deficit reduction to spending increases. A complete examination of the economic side-effects of tax increases, even consumption taxes, reveals that new taxes will reduce savings, lower investment and slow economic growth.

Are Tax Cuts Responsible for the Deficit?

Tax cuts have not been responsible for the deficit. Even a cursory examination of federal revenue data reveals that there has been no cut in tax revenues despite the fact that marginal tax rates were reduced. With the exception of a one-year recession-induced drop in revenues, federal tax revenues have increased in every year since 1980. Since taxes continue to absorb exactly the same share of GNP as they did before the deficit exploded -- 19.4 percent -- it should be obvious that the contemporary deficit does not result from tax cuts.

Does the Nation Require Increased Spending?

Increased government spending only can come at the expense of economic growth. Contrary to a prevelant mythology, federal spending has not been slashed over the past 8 years. The rate of growth in federal spending averaged 11.3 percent a year between 1980 and 1986 compared to a 9.3 average annual rate of increase in federal revenues. All of the major safety net programs grew in real terms between 1980 and 1988. During this period, Social Security (OASDI) rose at an average annual real rate of 3.2 percent; Medicare spending rose at an average 6.9 percent annual real rate; and health care services other than medicare grew in real terms at a 3.7 annual real rate. Even the slowest growing component of the budget, income security, grew in real terms over the 1980-1988 period. Including unemployment insurance, income security programs grew at a 0.2 percent real rate. This figure, however, understates the growth in transfers to the truly needy because the post-recession economic boom permitted unemployment programs to decline in real terms. Excluding unemployment, the rest of the income security budget category grew at an average real annual rate of 1.4 percent.

Conclusion

The record speaks for itself. Tax revenues have increased and the deficit is shrinking. Because a tax increase is likely to be a vehicle for additional government spending rather than less, it is as likely to increase the deficit as it is to reduce the deficit. The major threat to continued economic expansion is increased government spending financed by higher taxes. A tax increase would slow economic growth since it is more likely to reduce the amount of money available for productive investment rather than to increase it and increasing taxes will reduce the incentives for productive economic activity. By slowing economic growth, a tax increase would threaten to cripple the most effective bulwark against poverty and unemployment.

DO WE NEED A TAX INCREASE?

THE ARGUMENT FOR A TAX INCREASE

As measured by the comments of a majority of the nation's leading economic commentators and editorial writers, the conventional wisdom is that the United States needs a tax increase. Day after day, Vice President Bush is ridiculed as unrealistic and untruthful for insisting he will not raise taxes. Even Governor Dukakis, who admits readily that he holds open the option of higher taxes, is treated with mild disdain for qualifying his position. The Governor maintains that he will raise taxes "only as a last resort."

The belief that taxes must be raised has its roots in the following argument that often is made in full or only in part:

Premise: The United States is awash in debt and consequently faces rising interest rates and a capital formation crisis;

Premise: Raising taxes to reduce the budget deficit would significantly increase investment and lower interest rates.

Premise: The Reagan "tax cuts" were so deep that it would require unacceptably large spending cuts to balance the budget by bringing expenditures down to the level of revenues; and

Premise: The country has so many unmet needs that government spending should be increased, not decreased.

Therefore: A tax increase is unavoidable.

This chain of reasoning would be air-tight but for one problem: All of the premises of the argument are false.

HOW LARGE IS THE DEFICIT?

The Federal Deficit Relative to Current GNP. The first myth in the argument for increasing taxes is that the federal deficit is dangerously large. This myth has been perpetuated by too great a concentration on the deficit's size in terms of absolute nominal dollars.

Relative to the size of the nation's output, it is an exaggeration to characterize the federal budget deficit as massive. In 1980, the federal budget deficit was $73.8 billion, which amounted to 2.8 percent of GNP. By 1983, the deficit had been driven by a particularly severe recession and unusually high interest rates to a post-war high of $207.8 billion or 6.3 percent of GNP. [1] By 1987, the federal deficit had fallen to 3.4 percent of GNP, and in 1988 the bipartisan budget agreement will hold the deficit to a maximum of $146 billion, or about 3.1 percent of GNP, close to its 1980 level.[2]

The federal government has run a budget deficit in 34 of the 42 years since the end of World War II. Deficits averaged 1.6 percent of GNP over this period. By post-war standards then, a deficit of 3.1 percent of GNP remains above average but not of crisis proportion. Moreover, the deficit has ceased growing and is now declining, assuring that the burden it places on the economy will diminish over time.

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[1] The Federal Reserve Board used brute force to bring inflation down by pushing interest rates to extraordinary highs and driving the economy into recession.. Interest rates peaked on a per annum basis in 1981, the year the recession began, and dropped only slightly in 1982 during which the recession was most severe. In 1981, the prime rate averaged 18.87 percent and the interest rate on 90 day Treasury Bills averaged 14 percent. In 1982, the average Prime Rate fell to 14.86 and the interest rate on 90 Day Treasury Bills declined to 10.7 percent on average. A recent analysis by the U.S. Treasury Department found that "the business cycle and compounding high interest rates -- not changes in tax structure or programmatic spending -- are the causes of the major 1982-83 jump in the federal deficit. ...It appears that the government deficit problem is not a matter of fiscal strategy, but must be related to the behavior of the cyclical deficit and interest rates." (See Darby, Michael R., Research Paper No. 8704, "Accountingfor the Deficit," U.S. Treasury Department, October 2, 1987)

[2] Unless otherwise noted, all U.S. budget figures are taken from *Historical Tables: Budget of the United States Government*, U.S. Government Printing Office, Washington, D.C., 1988.

The Federal Deficit Relative to Future GNP. It is frequently argued that running large contemporary deficits mortgages the nation's future. Make no mistake, persistent budget deficits generally are undesirable for a whole host of reasons discussed below. However, it is easy to overstate the magnitude of the economic burden generated by budget deficits. Once the issue becomes politicized, it is expedient for some politicians to overstate the benefits of reducing the deficit quickly without considering the economic costs of doing so.

As anyone who holds a home mortgage understands, the effects of growing real income greatly reduce the current burden of debt acquired at an earlier date. As long as deficits do not grow larger every year, they become less burdensome each year the economy grows and/or inflation persists. For example, a deficit of $150 billion in 1987 represented 3.4 percent of GNP. With annual GNP growth of 7 percent (say, 3 percent real growth and inflation of 4 percent), a $150 billion deficit in 1990 would equal only about 2.7 percent of GNP, a reduction of over 20 percent in three years.[3]

The Total Governmental Sector Budget Deficit. A preoccupation with the federal government also helps to perpetuate the false impression that the economy is staggering under a crushing burden of government deficits. When evaluating the economy-wide effects of government borrowing, such as the effects on private capital formation, it is necessary to consider total state, local and federal government borrowing. In 1987, all three levels of government combined spent only $103.3 billion more than they raised in revenues because the state and local sector actually ran a budget surplus on balance. This total governmental sector deficit amounted to only 2.3 percent of GNP.

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[3] The same holds true, obviously, for the much larger federal debt. Given a national debt of approximately $2 trillion held by the public, the effects of inflation alone dramatically diminish the debt burden. In a single year, a 4 percent inflation rate erodes the real value of the debt by some $80 billion.

When the total governmental sector deficit is considered, the United State compares quite favorably to other industrial nations. In 1986, total governmental budget deficits in the OECD nations averaged 3.4 percent of GNP compared to 3.8 percent in the United States. Since that time, the U.S. government deficit declined more rapidly than it did on average among the OECD countries. In 1987, OECD total governmental deficits averaged 2.5 percent of GNP compared to 2.3 percent in the United States.

Summary. The federal budget deficit shot up to historically high levels in the aftermath of the 1981-1982 recession, after which it fell back substantially. In 1988, the total governmental sector deficit in the United States is comparable to the total deficit of other industrial nations. Even if deficits do not fall in absolute terms, if they at least do not increase beyond current levels, the burden they place on the economy will decline automatically as a result of real economic growth. To the extent that inflation persists, the future burden of today's deficits will be diminished even further by the inflation tax levied on current holders of government debt. In conclusion, the economic facts do not warrant continued hyperbole concerning the size of the federal budget deficit.

DOES THE NATION FACE A CAPITAL FORMATION CRISIS?

Two persistent myths in contemporary reporting on the economy are that the United States faces a crisis of capital formation because Americans are not saving enough and investment is lagging. Each myth is examined below.

American Savings Behavior. The reportedly low U.S. savings rate is usually criticized -- and is frequently contrasted unfavorably with Japan's rate -- because it undermines the ability to finance productive investment. The personal savings rate decline began in 1974. There is, however, controversy over how to measure the national savings rate properly. Numerous experts argue that the low American savings rate is largely a statistical artifact of the official method used to measure personal savings in the United States. For example, increases in household net worth are excluded from official savings data as are all civil service pension funds, which are credited to government savings. Moreover, proportionately more savings in the United States is business savings than is the case in other industrial countries.

When all sources of savings are added up, the U.S. savings rate is significantly higher than usually reported. Using similar measures of savings for the U.S. and Japan (including stock market values), Japanese researchers find that in 1985 (the most recent year for which data are available) the U.S. savings rate was 14.7 percent compared to 16.7 percent in Japan -- a much smaller difference than is commonly reported. [4] Increases in wealth measured in dollars are still larger for the United States than any other country, approximately $500 billion per year or $2,072 per capita. Japan has averaged only $176 billion in annual wealth increases or $1,449 per capita.

Investment in the United States. Growth in fixed investment averaged only 1.9 percent a year during the entire 1973-1982 period. During the 5 years spanning 1978 to 1982, fixed investment fell by more than $100 billion, and corporate profits declined. Since 1983, fixed investment has grown at an average annual rate of 6.6 percent. Over the same time span, the growth rates of fixed investment in Canada and France actually fell, while they rose only slightly in Japan and Germany. During the first quarter of 1988, fixed investment in the U.S. rose at an annual rate of 21 percent.

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[4] Ohmae, Kenichi, "Americansand Japanese Save About the Same," *Wall Street Journal, June 14, 1988.*

U.S. companies invested heavily abroad during the late 1970s partly because of high income tax rates and double-digit inflation that eroded after-tax profits in the U.S. and made depreciation allowances obsolete. Tax rates were reduced in the early 1980s, inflation was brought down, and as a result, U.S. investment and corporate profits have begun to soar again. During the last five years, real private investment rose by more than $200 billion, while corporate profits doubled.

Average Annual Growth Rate in Fixed Investment

Country	1973-82	1983-87
United States	1.9	6.6
Canada	4.9	4.7
Japan	4.4	5.3
France	2.3	0.2
Germany	1.1	1.7

Source: *OECD Economic Outlook*

Increasing Capital Formation by Tax Reform. While it may be true that Americans save and invest less than is desirable to achieve maximum economic growth, it is a gross exaggeration to characterize current rates of savings and investment as crisis-provoking. Certainly, a greater rate of capital formation is desirable, however it makes no sense to seek greater capital formation by imposing taxes on investment. The secret to achieving greater savings and investment is to reform that section of the tax code that currently places an undue burden on savings and investment.

The greatest boost to capital formation would result from reversing the mistake made in the 1986 Tax Reform Act of increasing the capital gains tax rate -- to 33 percent for individuals and 34 percent for corporations. How quickly members of Congress forgot the damage high capital gains taxes did during the 1970s. In 1978, the individual capital gains rate was cut from 49 to 28 percent and further reduced in 1981 to a top rate of 20 percent. Over the next five years, capital formation surged. In 1986, Congress chose political expediency over good economics when it chose to raise the capital gains tax rate again.

Higher capital gains tax rates are economically counterproductive and will reduce federal revenues. High capital gains rates reduce venture capital formation and hinder the ability of small businesses to raise capital. Perhaps most importantly, high capital gains tax rates reduce market liquidity by providing a powerful disincentive to realize gains. This "lock-in effect" of high capital gains rates actually costs the government revenue. Conversely, the capital gains rate reductions of 1978 and 1981 demonstrably increased federal revenues, and most economists that have analyzed the empirical data have come to the conclusion that a reduction in the present rate would increase revenue. Cutting the capital gains rate is just about the only pro-growth tax "increase"available to policy makers.

Recent research conducted by the U.S. Treasury Department confirms these claims. The Treasury study demonstrates conclusively that a reduction of the capital gains tax rate would not reduce revenue, and the research provides convincing evidence that such a rate reduction actually would increase revenues.[5]

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[5] Darby, Michael R., Robert Gillingham and John S. Greenlees, Research Paper No. 8801, "The Direct Revenue Effects of Capital Gains Taxation," U.S. Department of the Treasury, May 18, 1988.

Other mistakes were made in the 1986 Tax Reform Act that stand in need of correction to enhance capital formation. The capital cost recovery allowances available to industry under the 1986 Act are inadequate. The higher cost of capital implicit in this new regime will reduce our capital stock, productivity and competitiveness.

Most forms of savings mechanisms that reduced the double taxation of savings income implicit in an income tax were scaled back by the 1986 Act. In particular, Individual Retirement Accounts and section 401(k) plans were made unavailable to millions of middle class taxpayers trying to provide a sound basis for their retirement.

Summary. The best way to improve capital formation in the United States is to reduce the burdens on savings and investment at the sources. First, Congress should hold down the rate of growth of federal spending. Second, Congress should repeal distortive tax policies that increase the cost of capital and discourage savings.

WILL TAX INCREASES INTENDED TO REDUCE THE DEFICIT ACTUALLY REDUCE THE DEFICIT, REDUCE INTEREST RATES AND INCREASE INVESTMENT?

The ability of an economy to continue growing depends critically upon adequate capital formation. Every dollar diverted from the private sector into the public sector reduces the flow of savings available for private capital investment. The fear that government may crowd out private sector investment, therefore, is genuine.

Proponents of tax increases err, however, when they overemphasize the "crowding out" effects of deficits as compared to tax financing and when they underestimate the negative economic consequences of tax increases. More fundamentally, advocates of tax increases err when they ignore the fact that it is the total level of government spending, regardless of how it is financed, that places the real burden on private capital markets.

Boosters of tax increases bias the outcome of their analysis in favor of tax increases by taking the current level of government spending as a given. Then, they pose the policy choice as being between deficit finance or tax finance of a fixed level of spending. Within this framework, proponents of a tax increase adopt a static economic model to predict what will happen when taxes are raised.

The Static Economic Model. The static economic model on which proponents of tax increases base their argument runs as follows: Using deficits to help finance a given level of government spending both soaks up private savings that otherwise would be available for private investment and raises interest rates above what they otherwise would be. Raising taxes would decrease the government's drain on the flow of savings by the amount of the tax increase because government no longer would have to borrow that amount in the credit markets. People would reduce savings somewhat to pay their higher taxes but not as much as government's demand for credit would fall, since people will pay part of their increased tax bill by reducing consumption as well. The net effect of higher taxes, if used to reduce the deficit, would be to increase the supply of private savings available for private investment and to reduce interest rates.

The problem with this model is that it is incomplete. It fails to take into account the detrimental effects of tax increases and it fails to focus on the real sources of the problem regarding capital formation -- excessive government spending and distortive tax policies. Furthermore, the model operates in a world of comparative statics in which adjustments are instantaneous and without side-effects.

Few economists dispute the fact that, to some extent, deficits increase real interest rates, reduce private capital formation and create inflationary pressures. [6] The inflationary pressure is created as a side-effect of the upward pressure on interest rates generated by deficits. When government borrowing puts upward pressure on interest rates, the Federal Reserve Board is tempted to intervene to keep rates from going too high. The FED accomplishes this feat by printing more money than it otherwise would. In other words, the FED monetizes the deficit by allowing the money supply to grow more than is warranted by the real rate of economic growth, which causes inflation.

In dispute is how successful the political process can be in devoting a tax increase to deficit reduction; how much more deficit financing reduces capital formation than an equivalent amount of tax financing; how much higher deficits raise interest rates than an equivalent amount of tax financing; and the extent to which the economic side-effects of reducing an existing deficit quickly with tax increases will more than counteract any beneficial effects on capital formation and interest rates. Allan Meltzer, who has defended the notion that "deficits count" against the more iconoclastic neo-Ricardian view that they have no macroeconomic effect, places the controversy in context:

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[6] While the popular discussion of budget deficits has reached the point of hysteria, suggesting that the U.S. economy is on the brink of calamity, the academic discussion has gone in exactly the opposite direction. In a seminal 1974 article, Robert Barro argued that the "fiscal effects involving changes in the relative amounts of tax and debt finance for a given amount of public expenditure would have no effect on aggregate demand, interest rates and capital formation." (See Barro, Robert J., "Are Government Bonds Net Wealth?," *Journal of Political Economy*, 1974, vol. 82, no. 6, pp. 1095-1117) In this so-called neo-Ricardian equivalence context, the deficit is equal to the present value of future lump sum taxes and it has no macro economic effects per se. In a recent paper, Allan Meltzer sums up the current state of research on budget deficits: "A considerable amount of empirical research has not isolated reliable or consistent effects of deficits, debt, expected deficits or debt on real interest rates. Theoretical work on deficits, debt and capital accumulation finds such effects in models when income redistribution is admitted or in models with finite horizons. Some models find effects of the deficit on investment, although writers may recognize that the estimates are tenuous." (See Meltzer, Allan H., "Economic Policies and Actions in the Reagan Administration," paper prepared for the session "An Economic Assessment of the Reagan Years with Different Paradigms," Chicago, December 28, 1987)

> Public hand-wringing about the deficit is surprising, to put it mildly. ...The effect of the deficit on investment, holding the composition of government spending constant, strikes me as secondary to the direct allocative effects of government spending.[7]

Incompleteness of the Static Model. A number of considerations are omitted from the conventional static economic model that, when factored into the analysis, completely reverse the judgment in favor of tax increases. First, a suppressed premise of the model is that the tax increases under consideration will come from non-distorting taxes, usually taken to be lump-sum taxes for analytical simplicity. Of all the possible simplifying assumptions one could make, this is the least realistic.

The tax increases enacted in 1982, 1984 and 1987 all came primarily at the expense of savings and investment. Moreover, the overwhelming majority of the base-broadening provisions in the 1986 Tax Reform Act also increased the relative cost of saving and investment. Businesses and individual savers and investors will remain attractive political targets as long as a "soak the rich" ethic has the upper hand.

A common mistake is made by analysts who assert that the impact of a consumption tax on savings and investment is negligible. A consumption tax is a proportionate tax on all factors of production, including capital and labor. A consumption tax reduces the return to all inputs. Thus, the notion that a consumption tax exempts savings and investment from taxation is wrong. The only virtue of a consumption tax is that it does not tax the return to capital twice as does the income tax.

Secondly, the model predicts that tax increases will yield increased investment and lower interest rates because government's demand for credit is anticipated to fall more than the supply of private savings. According to recent research conducted by the U.S. Treasury, [8] proponents of tax increases are substantially overestimating the extent to which a tax increase will reduce consumption rather than private saving. The recent Treasury study found that, at least in the first few years, tax increases will come largely (80 percent) out of private saving. Only about 20 percent of the tax increase will come from reduced consumption.

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[7] See Meltzer, *op cit.*, p. 12.

Finally, a central assumption of the static model is that the entire tax increase will go toward deficit reduction. The critical nature of the assumption is apparent in light of the above finding by the Treasury, and history clearly demonstrates the fallacy of the assumption. Last year's "budget summit" between Congress and the President offers persuasive evidence that even under the most propitious circumstances, part of any tax increase will be diverted from deficit reduction to increased public spending.

In a crises atmosphere after the October, 1987 stock market crash, taxes were raised by $29 billion over a two year period, yet the deficit was anticipated to decline no more than $21 billion (from $150.4 billion in 1987 to $129.5 in 1989). Only 72 percent of the tax increase was ever intended to go toward deficit reduction while 28 percent was destined for spending increases. Using Treasury's estimate that only 20 percent of any tax increase is likely to come out of private consumption, one must conclude that no net increase in private investment resulted from last year's tax increase. To the contrary, the net effect of this tax increase was to decrease savings below what they would have been and to increase consumption -- public consumption. The real effect of the tax increase was to substitute more public consumption for private consumption and private savings. The discouraging aspect of this illustration is that it represents the best possible combination of events one could anticipate to force politicians to devote all of a tax increase to deficit reduction.

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[8] Darby, Michael R., Robert Gillingham and John S. Greenlees, Research Paper No. 8702, "The Impact of Government Deficits on Personal and National Saving Rates," U.S. Treasury Department, August, 1987.

Extraction Costs of Taxation. All taxes impose extraction costs on the economy over and above the total of the tax dollars collected by the government. These extraction costs can be viewed as the overhead cost of raising tax revenues that is borne by the private sector. Taxation, like any extraction process, entails diminishing returns. Recently, several economists have analyzed the cost of raising tax revenues to fund public spending and found the cost of extracting the taxes to be a significant share of the revenue raised.

One kind of extraction cost results from the burden of complying with tax laws. An illustration of this was reported in the 1985 *Report of the President's Council of Economic Advisers*. The report noted that the real compliance burden of record keeping and tax preparation were substantial both to individuals and businesses. The Council Report cited one study that found the average private compliance cost of Federal and State personal income taxes to be between five and seven percent of the revenue raised.

The other major type of extraction cost results because people dislike transferring their income to government and alter their behavior in response to a tax. For example, suppose the government decides to finance expenditure by raising marginal tax rates on income. An individual deciding whether to work an additional hour now finds that the after-tax return from the extra work is lower or alternatively that the opportunity cost of not working the extra hour, that is the cost of enjoying an hour of leisure, is now lower. Since leisure is a good, economic theory predicts that, holding all else constant, as the cost of leisure falls as a result of rising marginal tax rates, individuals will consume more leisure

-- they will work less. Thus, extraction by raising marginal tax rates is costly because individuals will work less (at least in the taxed sector) thereby reducing national income.

In a study by Shoven and Whalley, the authors estimate that raising the tax on capital in manufacturing from 0 percent to 50 percent results in a welfare loss equal to almost one-fourth of the tax revenues. [9] For every dollar raised in taxes, the private sector bears an additional 25 cent burden. For public spending financed by such a tax to be cost efficient, society must experience a rate of return in excess of 25 percent. Once at a 50 percent tax rate, the authors found that the marginal deadweight loss from raising another dollar of revenue from the tax on capital was almost 80 cents. The rate of return on public expenditure of each additional dollar would have to exceed 80 percent -- a return of $1.80 per dollar of cost -- if such spending is to add to national income rather than detract from it.

Ballard, Shoven and Whalley found, assuming a conservative labor supply elasticity of .15, that the welfare loss from a 1 percent increase in income tax rates is 28 cents per dollar of extra revenue. [10] Additional public expenditures funded from broad based income taxes, therefore, actually will reduce national welfare unless their marginal benefits are at least 28 percent greater than the revenues needed to fund the project.

Given the high overhead costs of raising taxes, public spending must generate very high rates of return to make it worthwhile. Many public spending programs that on the surface appear cost effective are in fact wasteful when the marginal excess burden generated by raising the additional taxes to pay for the programs is taken into account. Likewise, any economic model that posits positive macroeconomic benefits from raising taxes to reduce the deficit must also factor extraction costs into the equation. When the reality of extraction costs is added to the findings of the previous section, it becomes even less plausible that tax increases to reduce the deficit would accomplish the objective of strengthening the national economy.

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[9] See Shoven, John B. and John Whalley, "Applied General Equilibrium Models of Taxation and International Trade: An Introduction and Survey," *Journal of Economic Literature*, Vol. XXII, September, 1984, pp. 1007-1051.

[10] Ballard, Charles L., John B. Shoven and John Whalley, "General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the U.S.," *American Economic Review*, March, 1985, pp. 128-138.

Summary. This section has been devoted to demonstrating why tax increases will not accomplish the objective of strengthening the economy by reducing the deficit. First, it was shown on balance that proponents of tax increases greatly overstate the potential of a tax increase to increase investment and reduce interest rates. Secondly, the static economic model was elaborated to account for important considerations routinely ignored by proponents of tax increases. It was then shown why a tax increase should be expected to weaken the economy. Next, it was demonstrated that political reality makes it virtually certain that tax increases would be substantially diverted away from deficit reduction toward increased spending further calling the efficacy of tax increases into question. Finally, empirical findings were reviewed that reveal heavy extraction costs of taxation that further call into doubt the prudence of a tax increase.

ARE TAX CUTS RESPONSIBLE FOR THE DEFICIT?

Tax cuts have not been responsible for the deficit. Even a cursory examination of federal revenue data reveals that there has been no cut in tax revenues despite the fact that marginal tax rates were reduced. With the exception of a one-year recession-induced drop in revenues, federal tax revenues have increased in every year since 1980. Since taxes continue to absorb exactly the same share of GNP as they did before the deficit exploded -- 19.4 percent -- it should be obvious that the contemporary deficit does not result from tax cuts.

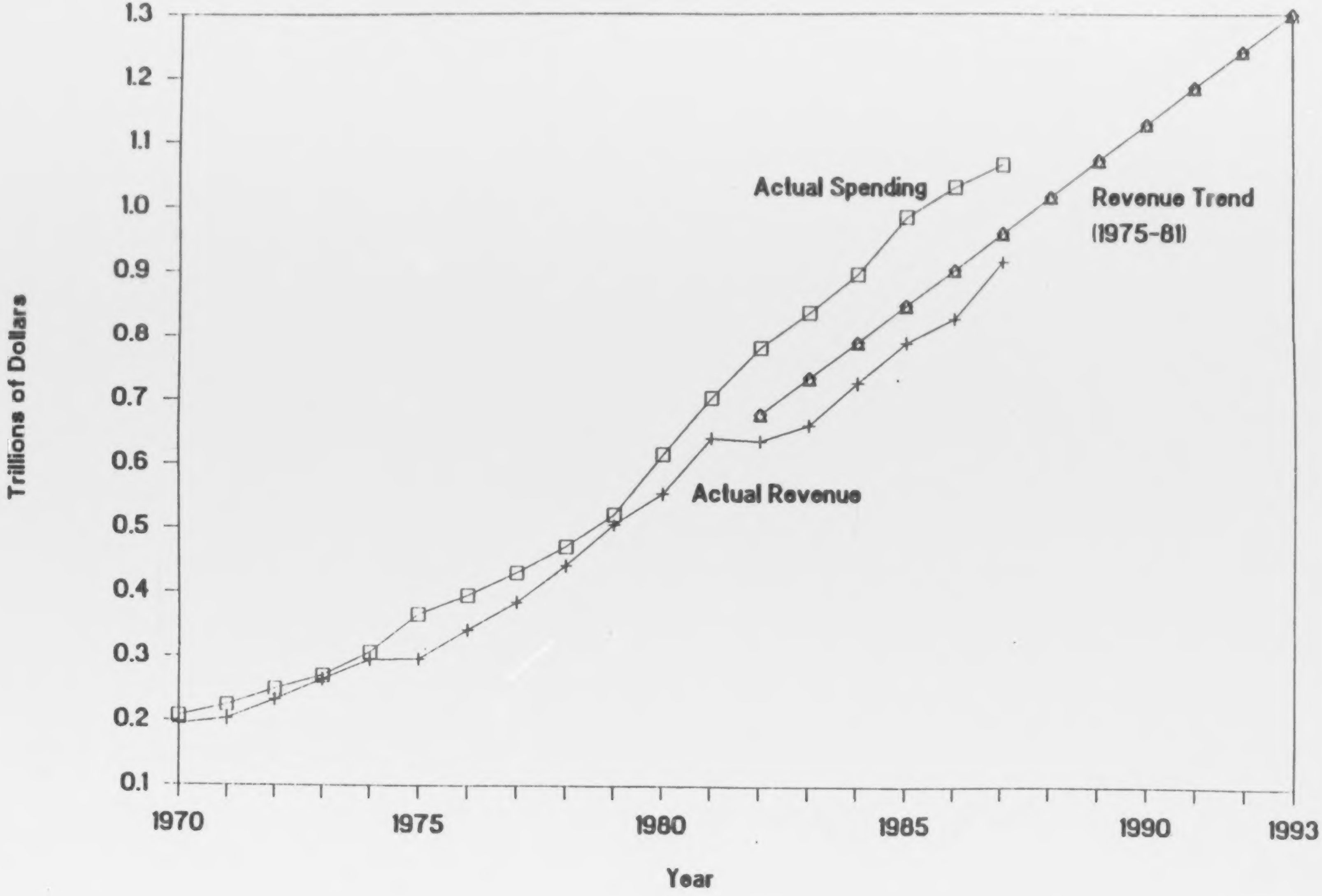
The sudden explosion of the federal budget deficit between 1979 and 1986 was the result of two fiscal phenomena: an acceleration in the rate of increase in federal spending, which began in 1979, and a recession related, one-time reduction in the revenue base from which federal revenues grew, albeit at an accelerated pace, after 1982.

The magnitude of the deficit-producing discrepancy between spending and revenue growth rates is illustrated by comparing the average annual rates of change in spending and revenues between 1980 and 1986. Federal revenues increased at an average annual rate of 9.3 percent during this 6 year span, which virtually matches the 9.5 percent growth rate of nominal GNP. The rate of growth of federal spending, by comparison, exploded over this same time period running at an average annual rate of 11.3 percent.

Since 1986, the rate of growth in federal spending has been reduced dramatically to 3.3 percent a year. Revenues continue to rise in the neighborhood of 9.3 percent. The deficit, not surprisingly, has shrunk dramatically as well since 1986, from $221.2 billion to an estimated $146.7 billion in 1988.

The graph below illustrates how the deficit may be partitioned in two based upon its two sources -- increased spending and the recession. The area above the 1975-1981 revenue trend line represents that portion of the deficit caused by accelerating spending growth. The area below that trend line represents the portion of the deficit resulting from

Federal Revenue and Spending



depression of the revenue base by the 1981-82 recession. [11] The table below provides details on the composition of the deficit since 1982.

COMPONENTS OF THE FEDERAL DEFICIT
(Billions of Dollars)

YEAR	FEDERAL DEFICIT	SPENDING ACCELERATION	REVENUE BASE DISPLACEMENT
1982	145.9	103.9	42.0
1983	176.0	102.1	73.9
1984	169.5	105.2	64.3
1985	196.1	137.8	58.3
1986	204.7	128.7	76.0
1987	151.4	107.2	44.2

Source: U.S. Chamber of Commerce staff calculations based upon National Income and Product Accounts.

DOES THE NATION REQUIRE INCREASED SPENDING?

The Federal Spending Myth. Two fiscal myths have flourished during the 1980s. The first -- that the federal budget deficit results from massive tax cuts -- was discredited in the previous section. The second myth -- that federal spending, especially human services programs, have been slashed over the past 8 years -- is addressed in this section.

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[11] This graph and the accompanying table are based on calender year budget data taken from the National Income and Product Accounts (NIPA). The NIPA receipts and expenditures data are the most appropriate measure of government activity in relation to the national economy at large. The Revenue Trend line is estimated by extrapolating the 1975-1981linear trend in revenues (the slope of which had increased from the pre 1975 period) out to 1993. This line represents an estimate of what federal revenues would have been had the revenue base not been displaced by the 1981-82 recession. (See also, Roberts, Paul Craig, "While Critics Carp, the Supply-Side Revolution Sweeps On," *Business Week*, April 25, 1988, p. 15) Notice that subsequent to the recession, actual revenues grew slightly *faster* than the pre-recession trend, offering further evidence that the marginal tax rate cuts were not responsible for any revenue loss. At current rates of growth, the recession effects on revenues will have disipated completely within the next 1 or 2 years. The graph also illustrates how federal spending began to diverge dramatically from its historic trend after 1979.

The task of myth-making on the spending side is to reconcile the reality of dramatic growth in federal outlays with the assertion of draconian spending cuts. This task is accomplished by exaggerations, distortions and outright falsehoods. Three basic techniques have been employed.

First, the myth-makers repeatedly refer to any reductions from the so-called current services baseline as "spending cuts." In fact, the current services baseline reflects a rising trend of outlays that significantly overstates the amount of outlays required from one year to the next to provide services under existing law. It is possible for programs to experience a real increase in funding and still be scored a "budget cut" by the myth-makers.

The source of this overstatement lies with the way inflation projections are treated in the current services framework. The current services baseline is based on inflation projections. Whenever actual inflation is less than projected inflation, as it has been frequently since 1980, limiting spending increases to the actual increase in the inflation rate, rather than the projected rate, has been interpreted paradoxically as a spending cut. Typically, Congress has elected to reduce spending from the current service baseline level to the level justified by actual inflation levels. This "reduction" is then counted as a "spending reduction" not just this year, but in every year that Congress maintains the original "reduction" in spending below the current service baseline.

By repeated reference to a hypothetical current services baseline that is based on inflation and growth projections, the myth-makers have been able to label spending increases as "cuts." For example, even though Medicare has increased at an average real rate of 6.9 percent since 1980, using the current services baseline for comparison makes it appear as though Medicare has been "cut" by more than $50 billion.

The most popular way to exaggerate the distortion of the current services concept is to claim that safety net spending has been slashed. This assertion simply is untrue. All of the major safety net programs grew in real terms between 1980 and 1988 in spite of cuts from the rising trends generated by the current services methodology. During this period, Social Security (OASDI) rose at an average annual real rate of 3.2 percent; Medicare spending rose at an average 6.9 percent annual real rate; and health care services other than medicare grew in real terms at a 3.7 annual real rate.

Even the slowest growing component of the budget, income security, grew in real terms over the 1980-1988 period. Including unemployment insurance, income security programs grew at a 0.2 percent real rate. This figure, however, understates the growth in transfers to the truly needy because the post-recession economic boom permitted unemployment programs to decline in real terms. Excluding unemployment, the rest of the income security budget category grew at an average real annual rate of 1.4 percent.

The final technique of the spending myth-makers is to exaggerate the extent to which defense spending has crowded out other components of the federal budget. National defense comprised about 5 percent of GNP in 1980, well below the 7 to 9 percent range defense had claimed of GNP during the 1960s. By 1980, real defense spending had fallen 17 percent below what had been a steady state level of funding in the peace-time era 1955-1966 between the Korean and Vietnamese Wars. In 1986, defense spending achieved a post-Vietnam high funding level at 6.5 percent of GNP, but in 1988, defense spending is expected to slip back to 6.1 percent of GNP.

The Myth of Unmet Needs. Elaborating on the myth that federal spending has been slashed is the myth of pent up demand for public spending. This argument runs that the past 8 years have permitted enormous "unmet"public needs to build up that now must be addressed with new spending.

It may be the case that citizens desire more public spending. It is just as plausible, however, that voters do not desire to resume the rapid growth of government experienced throughout the 1960s and 1970s. This is an empirical-political question that only can be determined by peoples' preferences, not by technical considerations of what is "needed"by society. What is amenable to technical analysis, however, is the economic cost that would accompany increased public spending. The following section examines these costs.

Government Spending and Economic Growth. An area of heightened interest among economists is the relationship between government spending and the rate of economic growth. A number of scholars have begun to estimate the economic effect of government expenditures on the supply side of the economy. A growing body of empirical evidence supports the hypothesis that there is a significant negative relationship between government spending and economic growth rates.

Grier and Tullock in their study of international growth rates have found a persistent negative correlation between the growth of government's share in gross domestic product and economic growth. [12] Barth and Bradley, who also studied the effect of government spending internationally, found a statistically significant negative relationship between government expenditure and economic growth rates in virtually every specification of the model they tested. As Barth and Bradley reported, "This finding holds for all levels of government as well as for all types of governmental spending."[13]

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[12] Grier, Kevin B. and Gordon Tullock, "An Empirical Analysis of Cross-National Economic Growth, 1950 - 1980," unpublished manuscript, George Mason University, May 1988.

These studies show that government expenditures reduce economic growth rates not only because extraction costs are substantial but also because many kinds of government expenditures have a negative effect on economic growth that is completely separate from the cost of extraction. The key to understanding how public spending by itself reduces income is to understand that not all government expenditure has the same effect on the economy.

Government spending is comprised of three basic components: transfer payments, purchases of goods and services and investment spending. Each type of government expenditure is likely to have different effects on output. Of the three components, investment spending is the only expenditure that possibly can lead to greater output. Transfer payments that require an individual to stop undertaking productive activity in order to qualify, reduce rather than expand economic output. For example, individuals will lose social security payments if they work and earn more than some threshold level. Welfare recipients in most cases will lose government benefits if they engage in full employment. Thus, transfer payments provide disincentives for individuals to be productive.

Purchases of goods and services only replace private consumption and do not increase income. In contrast, government expenditure on investment is the only possible form of spending that under certain conditions actually may increase economic growth rates. At low levels of government spending, economic growth also is low. In conditions of anarchy or weak government, the public goods and services essential for the proper functioning of markets -- personal property rights, police forces to protect the rights of people and property, an effective judicial system, national defense against foreign predation, and so forth -- simply do not exist.

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[13] Barth, James R. and Michael Bradley, *The Impact of Government Spending on Economic Activity*, The National Chamber Foundation, Washington, D.C., 1988.

Once government provides those essential public goods (a public good is an indivisible and nonexcludable good or benefit, like constitutional rights or national defense, that government alone can provide), it becomes more likely that increased government spending will weaken the economy. That is because government, if it continues to grow, inevitably begins to duplicate services provided by the private sector. Since the government has the power to grant itself a legal monopoly or oligopoly, it can prevent private firms from competing and can run enterprises on the basis of political, as opposed to economic, considerations.

A variety of factors, including the type of spending, undoubtedly influences the level at which government spending becomes counterproductive. Basic infrastructure payments, for instance, generally help the economy. Subsidies of all varieties do not.

What is indisputable is that the greater the level of government spending, the greater the chances that it will be put to less than optimal use. Public choice economists have established the behavioral theory for explaining this phenomenon.

As government spending grows and the number of beneficiaries increases, politicians begin showering money on distinct constituencies. Incredibly expensive federal programs, such as farm subsidies and urban mass transit programs, help small groups of people while weakening the economy generally. In addition, many well-meaning social programs, largely those associated with income transfers and cash assistance, have such adverse effects on savings and labor supply that they discourage productive activity. These all are the natural result of political incentives. Politicians get "paid" (re-elected) for directing government money toward their constituents.

Last year's budget compromise, which only succeeded in reducing the deficit by 72 cents for every dollar of new taxes, illustrates this process. The 28 cents of increased federal spending that resulted from the budget summit can be thought of as the political profit, a 28 percent commission, politicians skimmed off the tax increases. Of course this $8 billion was not divided equally into 535 payments for each member of Congress. Instead, the commission was taken in the form of political currency -- increased public spending conferred strategically on selected segments of the electorate. And, that currency was calculated to buy votes to help keep each member safely ensconced in office. It should not be surprising under these circumstances that the overall rate of re-election in the Untied States Congress currently stands at about 90 percent.

Politicians usually support the growth of bigger government by increasing taxes a little on many different taxpayers and then conferring the benefits in concentrated form on relatively small groups of beneficiaries. Given this arrangement, citizens confront a choice when they discover they are not receiving what they consider to be adequate return on their tax payments: they may organize a broad based citizen tax revolt to lower taxes or they may join together in special interest groups to seek concentrated benefits that will benefit them and increase their benefit/tax ratio while increasing taxes only a little on everyone. Except under very special circumstances, the latter strategy is the most politically effective.

Summary. The combination of high levels of government spending and the associated high tax burdens necessary to finance that spending effectively deprive the productive private sector of much needed capital. Thus, as government becomes more "successful,"an economy can get increasingly weak. Theoretical and empirical work in several branches of economics offer confirmatory evidence that beyond a certain minimal level, growth in government comes at the expense of economic growth.

Studies on the welfare effects of taxation have shown that the marginal excess burden from raising new tax revenues is frequently higher than the return from any conceivable new government program. Public choice economists have provided a theory of political economy that explains why in a democracy politicians have both the motive and opportunity to expand government. Unless properly constrained, this theory predicts that governments possess a natural proclivity to grow.

In addition, a growing body of empirical evidence confirms that Congress tends to "spend"any tax increase and then some.[14] Others who have looked at the question have argued there is no significant relationship between tax increases and spending increases.[15] What is indisputably true is that there is no evidence that Congress has used tax increases to reduce deficits, nor is there any reason to believe they are likely to change their behavior. Finally, empirical evidence is mounting that economic growth rates will inevitably decline as the naturally expanding government adopts new spending programs with revenues absconded from over-taxed income-producing factors owned by private citizens. This relationship is depicted in the following illustration.

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[14] Vedder, Richard and Lowell Galloway, "Soakingthe Rich Through Tax Cuts," *Wall Street Journal*, March 21, 1985.

[15] Stein, Herbert, "The New Parkinson's Law," *Wall Street Journal*, July 13, 1988.

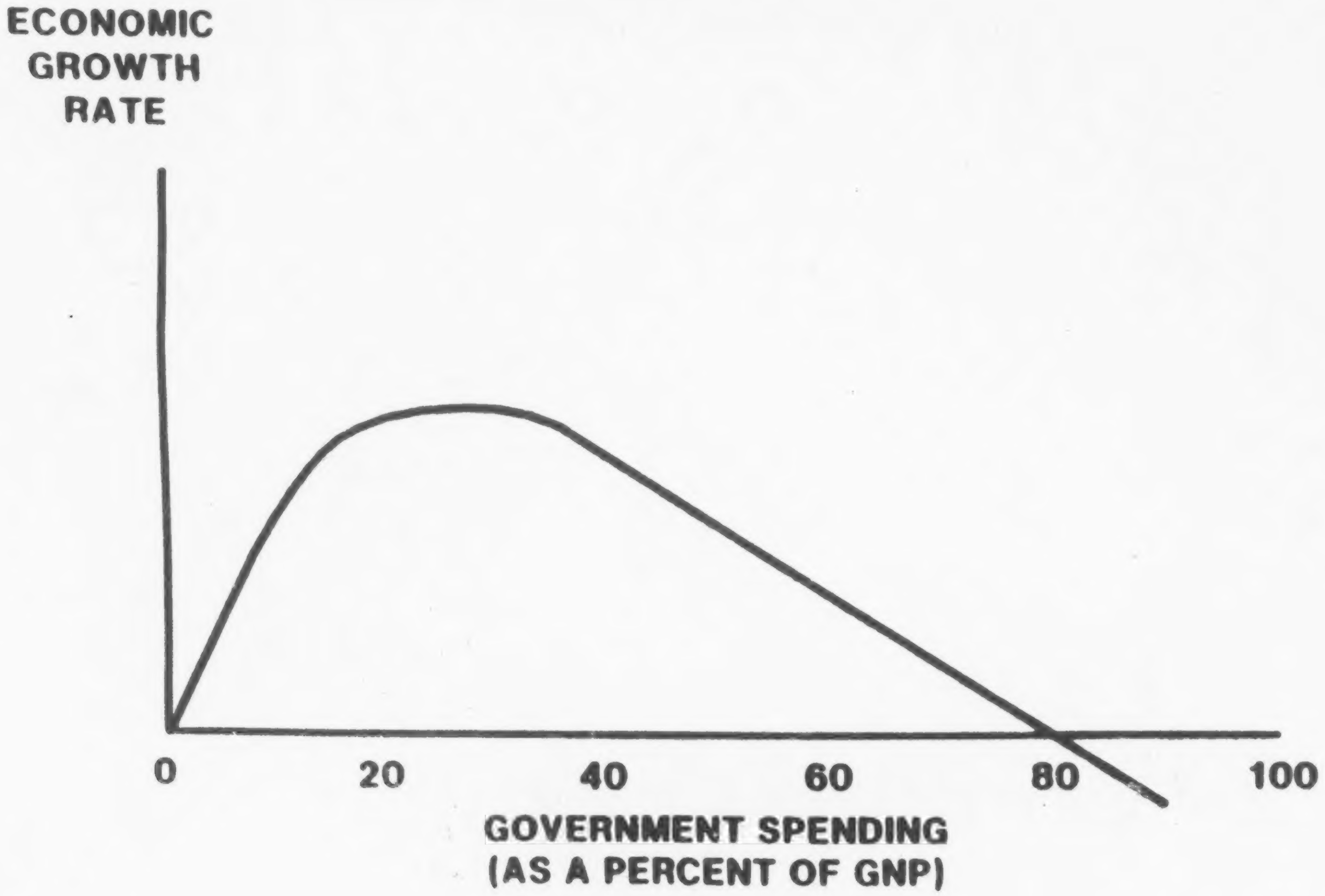
WE DO NOT NEED A TAX INCREASE

Fortunately, as a result of strong economic growth and effective restraints on spending growth stemming from the Gramm-Rudman-Hollings deficit reduction act, the federal budget is moving rapidly toward balance. Even using the Congressional Budget Office's (CBO) pessimistic projection of a 2.6 percent increase in real economic growth per year and a 4.5 percent average annual rate of inflation, the government would take in some $1.262 trillion per year by 1993, compared to the approximately $900 billion estimated for this year.

More realistic real growth assumptions -- such as the 3.3 percent per year average from the past forty years, which is still well below the 3.8 percent per year average of the last 5 years -- would yield a whopping $1.326 trillion per year by 1993. In short, enough money will come in over the next five years without a tax increase to eliminate the deficit by instituting a fair freeze on spending that would fund Social Security fully, pay the necessary interest on the national debt, and cover the inflation induced cost increases in every other government program now on the books. See Appendix I for details on the Fair Freeze.

Social Security payments are expected to be up approximately $52 billion per year higher by 1993 and interest payments are expected to cost $43 billion to $55 billion more per year by 1993. But, after these deductions from that year's expected tax revenue, there still will be an estimated $258 billion to $330 billion to apply to deficit reduction, increased spending on existing programs, new programs or tax reduction. Congress could add to the

GOVERNMENT SPENDING AND ECONOMIC GROWTH



pool of funds at its disposal by reducing or eliminating programs that are unjustified or not cost effective, such as, closing unneeded military bases.

Finally, Congress could add substantially to the pool of funds available for deficit reduction, while at the same time increasing the efficient delivery of many services, by adopting a number of the recommendations of the President's Commission on Privatization and recommendations from the Report of the Privatization Task Force (See Appendix II). Clearly, the budget can be balanced by 1993 without increasing taxes and without cutting Social Security or any other needed programs. The evidence is clear: tax increases slow economic growth and often lead to higher deficits -- remember the unfulfilled promises -- "$3 in spending cuts for every $1 in tax increases" -- when taxes were increased in 1982.

The record speaks for itself. Tax revenues have increased and the deficit is shrinking. The major threat to continued economic expansion is increased government spending financed by higher taxes. A tax increase would slow economic growth -- since it is more likely to reduce the amount of money available for productive investment rather then increase it -- thus crippling the most effective bulwark against poverty and unemployment. Because a tax increase is likely to be a vehicle for additional government spending rather than less, its effect on reducing the deficit will be minuscule, but its effect on the economy may be devastating.

Fortunately, there is a way both to increase funds available for capital formation and to eliminate the deficit without producing the negative side effects associated with tax increases. There is nothing magic about the solution. All Congress must do is hold the increase in government spending to the rate of inflation and begin privatizing those functions now performed by government that could be handled more effectively by the private sector. Congress and the President should "just say no" to a tax increase.

Appendix I

THE FAIR FREEZE SOLUTION TO BALANCE THE FEDERAL BUDGET

THE FEDERAL BUDGET CAN BE BALANCED BY 1993 WITHOUT CUTTING SPENDING AND WITHOUT RAISING TAXES.

- The federal budget deficit persists despite continuously rising federal revenues because the rate of growth in federal spending exceeds that of federal revenues.

- The Fair Freeze Solution to balancing the federal budget adjusts the growth rate of spending downward slightly to bring it into line with the rate at which revenues are growing.

- The Fair Freeze Solution is based on the assumption that the economy will grow at the same average annual rate it has over the last forty years.

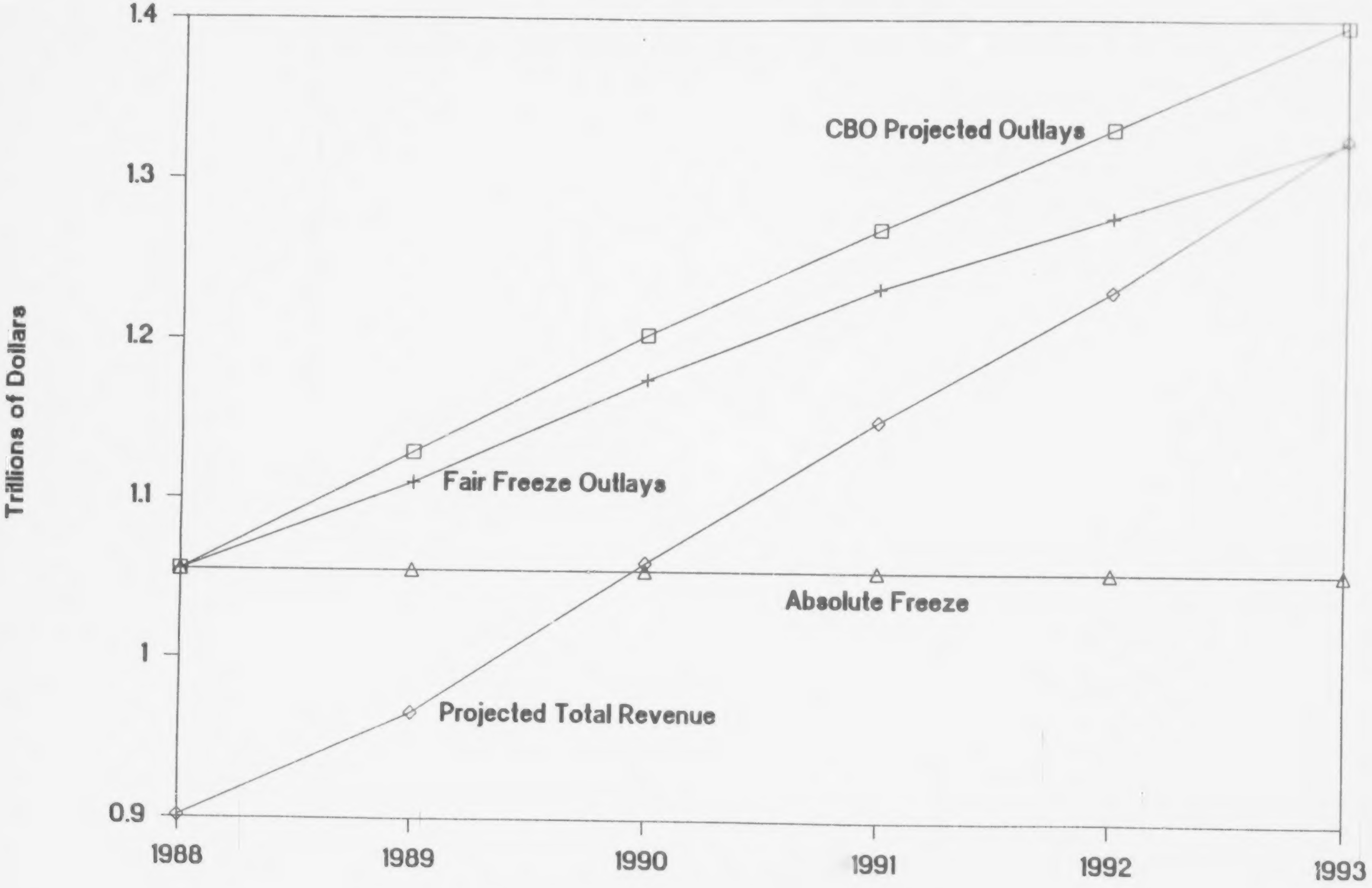
- The Fair Freeze Solution has three components:

    - Interest on the federal debt is allowed to increase at the rate estimated by the Congressional Budget Office (CBO). *No assumption is made that interest rates will decrease in response to falling deficits.*

    - Social Security benefits are allowed to increase at the rate CBO estimates is necessary to provide benefits called for under current law. *Social Security benefits are not touched.*

    - Remaining federal spending is permitted to increase at CBO's estimated rate of inflation. *No spending cuts are required.*

The Fair Freeze Solution *



* Based on 40 yr. ave. GNP growth rate

THE FAIR FREEZE SOLUTION *
(Fiscal years; in billions of dollars)

YEARS	SOCIAL SECURITY (a)	NET INTEREST (b)	OUTLAYS SUBJECT TO FAIR FREEZE (c)	CBO PROJECTED TOTAL OUTLAYS	FAIR FREEZE OUTLAYS (d)	PROJECTED TOTAL REVENUE (e)	FAIR FREEZE DEFICIT (f)
1988	203	151	701	1055	1055	901	154
1989	213	164	733	1129	1110	966	144
1990	225	181	769	1203	1175	1060	115
1991	237	192	803	1269	1232	1149	83
1992	246	193	838	1332	1277	1231	46
1993	255	194	875	1396	1324	1326	-2

* Assumes that the Average Annual GNP Growth Rate for 1988 to 1993 will equal the historic average rate for the forty-year period from 1948-1987 (3.27%)

(a) Social Security is allowed to grow at the rate CBO estimates is necessary to provide Old Age, Survivors, and Disability Insurance (OASDI) benefits as stipulated by current law.

(b) CBO Net Interest expenditures estimates adjusted to include net interest savings from higher GNP Growth Rate assumptions using CBO ten-year interest rate assumptions.

(c) Under a "Fair Spending Freeze" all spending except that for net interest and Social Security would be allowed to increase at the rate of inflation as projected by CBO.

(d) Fair Freeze Outlays are equal to the sum of Social Security, net interest and outlays subject to Fair Freeze.

(e) Total Revenue is based on the rule of thumb used by CBO to estimate the revenue effects of a change in real GNP growth.

(f) The Fair Freeze Deficit equals the difference between Projected Total Revenue and Fair Freeze Outlays.

Appendix II

POTENTIAL REVENUES FROM PRIVATIZATION

PROGRAM OR ASSET	UNITS TO BE SOLD	SALE VALUE ($ Billions)
Commodity lands (48 contiguous states)	272.9 million Acres/97.7 million acres	$136.0
Tennessee Valley Authority	Generating facilitis and transmission system	$ 12.3
Air Traffic Control	Control System	$ 0.0 - $2.0
Military Bases	Obsolete Bases	($ 0.1 per base minimum)
Postal Service	All Assets	$ 11.0
Electromagnetic Spectrum	AM & FM Radio and Broadcast TV airwaves	$ 8.6
Loan Portfolio	$250 billion value	$ 95.0
Naval Petroleum Reserves	2 Fields	$ 3.6 to $ 4.3
Dulles & National Airports	All Facilities	$ 2.5 to $ 3.0
Power Marketing Associations	5 Agencies	$ 13.9
Amtrak	Some Assets	$ 1.0
Total *		$307.9 to $311.1

* Figure does not include minimum of $5 billion from sale of 50 surplus military bases.

Source: Report of the Privatization Task Force, June 1988

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COMPETITIVENESS IS ALIVE, WELL, AND THRIVING IN AMERICA

by

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U.S. Chamber of Commerce

Policy Working Papers are published by the Economic Policy Division of the U.S. Chamber of Commerce to inform the American public about relevant economic policy issues. These studies are intended as timely and thought-provoking contributions to the national debate about these issues which are of particular importance to the U.S. business community and the public at large. Permission is granted to quote from this report with appropriate attribution to the Economic Policy Division, Chamber of Commerce of the United States.

EXECUTIVE SUMMARY

"America has lost it dominant position in the global economy." "America no longer has the world's highest standard of living." "Productivity growth is lagging behind that of other countries." "America is one more washed-up nation, declining inevitably from its greatness like other great powers of the past." These are the headlines. These are the myths.

In this policy working paper, the issue of American competitiveness is reexamined. The paper also demonstrates how some reports, such as the one by the Council on Competitiveness, manage to grossly exaggerate the well-being of other countries in comparison to that of the United States, while portraying the U.S. economy in the worst possible light. The paper concludes that, contrary to widespread reports, American competitiveness is resurgent. The American standard of living has never been higher, and the prospect for sustained improvement in the economic well-being of all Americans has never been brighter.

The most important single indicator for competitiveness is the standard of living. In 1987, U.S. real per capita disposable income, adjusted for inflation, was at an all-time high, growing steadily throughout the recovery from the last recession of 1981-82. Improvement in family income has been equally remarkable. Median family income also reached a record level in 1987.

Amazingly, the record on family income growth has been misinterpreted to support the stagnant-standard-of-living thesis. It frequently is reported that median family income only recently rose above the level it had attained in 1979, and is virtually identical to its previous all-time high of 1973. Based on this comparison, it is asserted that the American family's standard of living has not increased significantly in 15 years. Such reports neglect to mention what happened to family income during the economic malaise of the late 1970s and the recessionary aftermath in the early 1980s. After remaining stagnant from 1973 to 1977, median family income plummeted between 1978 and 1982. Since 1982, family income has rebounded at a rate unseen since the prosperous 1960s.

International comparisons of standards of living place this issue in perspective. Compared to other countries, U.S. per capita gross domestic product (GDP) is still far above that of Japan and Europe, including the Scandinavian countries.

U.S. manufacturing productivity growth for the past 5 years reached a postwar record, tripling its rate of the 1970s. Compared to other countries, U.S. manufacturing productivity growth was among the highest. While productivity growth has been on the decline in many other countries, it has been increasing steadily in the United States.

Investment also jumped after 1982 and is the main factor accounting for America's growing productivity. Per employed person, nonresidential gross fixed investment in the United States has been higher than in Japan and West Germany.

The economic trends established in the 1970s and the culmination of these trends in the severe recession of 1981-82 produced a well-founded and deep-seated anxiety among Americans concerning the United States' economic future. The years since 1982 should have provided the economic tonic to dispel concern over American competitiveness in the global economy. Instead, for many analysts and policymakers, the shadow of the 1970s stretches long into the present and eclipses America's remarkable economic resurgence of the past 6 years.

Introduction

"America has lost its competitive edge in the world and now faces economic decline." That is the message of a recent barrage of reports purporting to demonstrate the existence of an American competitiveness problem.[1] The message is false. A few reports have demonstrated a turnaround in America's competitiveness. The New York Federal Reserve recently reports that "U.S. manufacturing has clearly become more competitive in recent years. This achievement was the result of sharp dollar depreciation, wage restraint, and strong improvements in U.S. productivity and quality performance."[2] The competitiveness crisis is an imagined problem rooted in the bygone economic stagnation of the 1970s and the period of severe economic recession that immediately followed in the early 1980s. These economic body blows left the nation reeling in self-doubt and highly susceptible to a doom-and-gloom prognosis. At the time the American economy hit bottom in 1982, the idea of a "competitiveness gap" fit the national mood perfectly. By 1985, "competitiveness" had become a national buzzword. Research on the so-called "competitiveness gap" developed into a growth industry among think tanks and the *cause celebri* of interest groups across the land. Despite this growing fascination with competitiveness, there continues to be great confusion over the concept's meaning.

The Concept of Competitiveness

On the one hand, economics is like baseball; each has a blue-zillion statistics, but performance in both boils down to a single datum -- in baseball, it is the won/lost record, in economics, it is the standard of living record. On the other hand, economics is very much unlike baseball, in which one team wins at the other's expense. Economics is not a zero-sum game. To the contrary, free economies represent the ultimate cooperative social activity in which all may improve their plight without inflicting harm or privation upon others. Therefore, "competition" and "competitiveness" have quite different meanings in baseball and economics. Much of the problem with studies on American competitiveness results from a confusion between the two.

A competitive economy is one in which buyers and sellers, producers and consumers are free to maximize their wealth and satisfaction through commerce and trade. The material betterment of a nation's people made possible by the free conduct of commerce does not come at the expense of other nations. It is a mercantilist fallacy to label an economy "competitive" only to the extent that it outgrows or outsells or outproduces or outinvests or "outanythings" other nations.

The true measure of economic competitiveness is the extent to which an economic system is able to produce a rising standard of living for its citizens. What counts, therefore, is the level of economic well-being citizens enjoy and how rapidly that well-being is increasing relative to the past.

As in all human endeavors, it is natural to look for a measuring rod against which to judge success; in economics, that measuring rod is the performance of other economies. To the extent that such a comparison remains an analytical *means* to improve economic policy, it enhances economic growth. However, when improvement in the relative position of a nation on international rankings becomes an end in itself, the comparison ceases to have economic meaning or usefulness. Comparisons of this nature reflect the hot emotions of envy more than the cool intellect of scientific comparisons. What results is a counterproductive political contest that may generate harmful mercantilist policies and ultimately depress the standard of living.

To evaluate America's competitiveness, one should measure the absolute standard of living at a point in time and chart the change in that absolute standard over time. Several additional indicators are useful to assist in monitoring the ability of the American economy to continue producing increases in the standard of living. One such indicator would chart the change in the American standard of living relative to that of other countries. In addition, factors that are important in achieving a high standard of living, such as productivity, investment, and research and development, should be examined as supplements to any aggregate indices that are constructed.

The Construction of Indicators

The most commonly used indicator for measuring the American standard of living is real per capita disposable personal income. This indicator shows the average income available for each person after adjusting for taxes and inflation.

When comparing the relative standard of living among different countries, the most commonly used measure is real per capita gross domestic product (GDP) converted into U.S. dollars by using exchange rates. There are, however, many problems with using exchange rates to convert the GDP data. For example, exchange rates reflect only the prices of goods and services that are traded internationally. Since most services are not traded internationally, the differences between the prices of non-traded goods and services among countries cannot be captured through changes in the exchange rate. In addition, exchange rate movements often are determined by the decisions of monetary authorities of a group of nations; therefore, variations in the exchange rate frequently do not reflect the supply or demand of currencies determined by economic factors such as prices of goods. Regardless of the reason for a change in the exchange rate, such a change will produce a change in exchange-rate-converted GDP, even though the actual GDP remains unchanged.

In order to resolve these issues, purchasing power parity (PPP) exchange rates are introduced. PPP is defined as the ratio of one country's prices to another's for the same quantity of both traded and non-traded goods.[3] PPP exchange rates, which are expressed as units of foreign currency per U.S. dollar, represent the number of foreign currency units required to buy goods and services equivalent to what can be bought in the United States with one dollar. Thus, they are used to convert foreign GDP into a common denominator of U.S. dollars.

Some analysts argue for a different measure of the standard of living. The Council on Competitiveness proposes a standard of living index that is measured as GDP plus the current account balance, divided by the number of employed persons.[4] The rationale for including the current account balance is to "adjust each nation's total output for what is owed to foreigners." This definition of the standard of living is misleading and biased for three reasons. [illegible], the established measure of the nation's output (GDP) is composed of personal consumption expenditures, plus gross private domestic investment, plus government purchases of goods and services. Then exports, which are produced but not consumed in the country, are added to the sum, and imports, which are consumed but not produced in the country, are subtracted. Since net exports (exports minus imports) are a part of the current account balance,[5] adding the current account balance to GDP results in double counting.

Secondly, the use of total employment instead of population causes a bias when comparing the standards of living of different nations. The number of employees includes part-time workers as well as full-time workers. The United States has had the highest proportion of part-time employees relative to all employees in all G-7 countries[6] except the United Kingdom. For example, in 1986, the ratio of part-time employees to total employees in the United States was 17.4, compared to 11.7 in Japan, and 12.3 in West Germany.[7] Therefore, this usage would yield an undeserved lower standard of living for the United States, when compared to other countries, since part-time workers generally produce less than full-time workers. Moreover, such a measure is perverse. A country that has a lower employment-population ratio than another country, probably because of significant unemployment, can be interpreted as having a higher standard of living, even though the per capita GDPs of the two nations are about the same. Thus, a country is penalized for either having a higher proportion of part-time employees with respect to total employees or for having a higher employment-population ratio.

Thirdly, in addition to its technical flaws, the Council's measure is conceptually flawed. It commits the mercantilists' mistake of ignoring comparative advantage as the basis for trade patterns. With its index, the Council explicitly asserts that a country that strives for a current account surplus -- perhaps by erecting import barriers -- is by definition raising its standard of living. A country can also have a current account surplus because of large interest and dividend earnings from investments abroad. West Germany, for example, has a large current account surplus that is partly attributable to heavy investment abroad. With a 9 percent unemployment rate, however, Germany might be better off if some capital outflows were instead channelled to domestic use and resulted in increased employment for German workers.

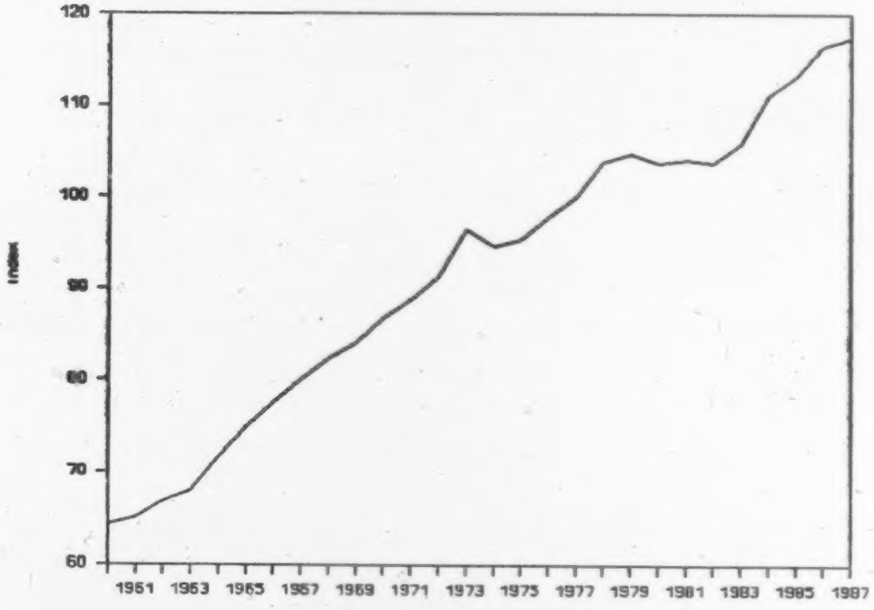
In addition to the above flaws in the definition, the Council on Competitiveness uses 1980 exchange rates to convert foreign data into U.S. dollars. No explanation is provided of why the 1980 exchange rate is superior to any other year to convert all the foreign data between 1970 and 1987. Yet, by selecting the 1980 exchange rate, the Council on Competitiveness grossly exaggerates the well-being of other countries in comparison to that of the United States, while portraying the U.S. economy in the worst possible light. The dollar exchange rate in 1980 was at its lowest before it rose to its peak in 1985, and then fell again until recently. In order to find the foreign nation's GDP in U.S. dollars, foreign exchange per dollar is used to divide a foreign nation's GDP. When the dollar is weak, it takes less foreign exchange to buy one dollar. A low dollar exchange rate means less foreign exchange per dollar. Since foreign exchange per dollar is the denominator, a smaller denominator yields a larger foreign GDP in terms of U.S. dollars. In other words, if the 1985 exchange rate were selected instead of the 1980 rate, the strong dollar would result in a much more favorable standard of living for the United States, because foreign currencies depreciated against the dollar by about 30 percent during the period 1980 to early 1985.

The U.S. Absolute Standard of Living Index

Real per capita disposable income grew steadily during the 1960s, then fell sharply in 1974 before rising again, only to stagnate between 1978 and 1982. After the 1981-82 recession, per capita disposable income began to rise steadily, reaching an all-time high in 1987. Between 1982 and 1987, real per capita disposable income rose at an average of 2.53 percent per year, compared to an average annual rate of 0.83 percent per year during the 1974 to 1982 period (see Chart 1).

CHART 1

Real Per Capita Disposable Income Index
(1977 = 100)



Source: Department of Commerce, Bureau of Economic Analysis & Bureau of the Census

Chart 1 shows the U.S. standard of living, measured by real per capita income after taxes, divided by the population. It shows per capita disposable income in 1982 dollars, indexed so that 1977 = 100.

Another measure of income is family income adjusted for the rate of inflation. Since 1982, real family income has increased by 11.8 percent. These recent increases have brought real family income to an all-time peak level, comparable to that of the previous peak in 1973, before a series of recessions resulted in substantial declines in real family income. The past 5 years of continuous growth in family income is the most sustained increase in 20 years.

The U.S. Absolute Standard of Living Versus Other Major Industrial Nations

Even though real output per capita (GDP) is not the most complete measure for the standard of living, it is the most commonly used indicator. While personal income is more relevant to the standard of living of a nation's citizens, the data on the income side of the national income account for other nations are not available. The published PPP exchange rate is used for converting only GDP, not for personal income; therefore, real GDP per capita is the only available measure for a comparison of international standards of living. Table 1 shows that the United States continues to enjoy the highest absolute standard of living in the world, including the Scandinavian countries, that are often thought to have the highest standard of living of all.

TABLE 1

Real Per Capita GDP in 1987
(In 1987 Dollars, PPP Exchange Rates)

Denmark	$13,240
Japan	13,198
Norway	15,563
Sweden	13,856
U.S.	18,289
W. Germany	13,349

Source: Bureau of Labor Statistics

While the rate of growth of the U.S. standard of living was slower than that of many industrial nations during the 1970s, a change in trends emerged recently. Between 1973 and 1982, the average annual growth rate of real per capita GDP in the United States was the lowest among the G-7 nations. From 1983 to 1987, however, the U.S. average annual growth rate was among the highest of these nations, only slightly lower than Japan's (see Table 2).

TABLE 2

Real Per Capita GDP
(Average Annual Rate Of Change)

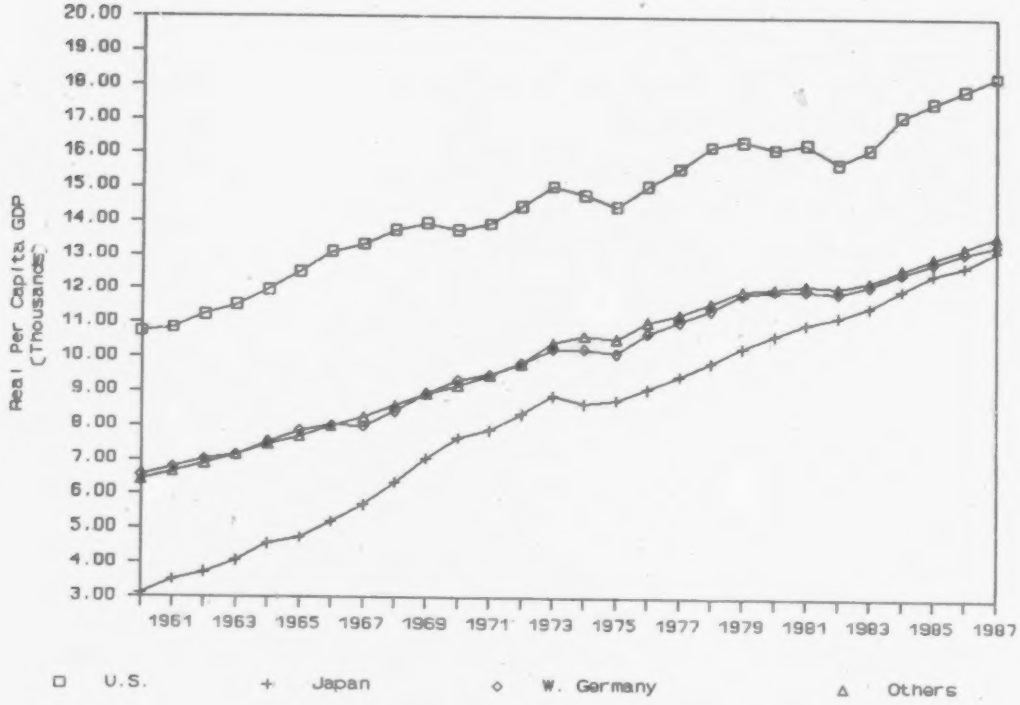
Country	1960-73	1974-82	1983-87
Canada	3.8	1.8	3.1
Japan	8.5	2.7	3.2
France	4.5	2.1	1.1
U.K.	2.6	0.8	3.0
U.S.	2.6	0.6	3.1
W. Germany	3.5	1.7	2.3

Source: Bureau of Labor Statistics

Even though most of the countries listed in Table 1 experienced a higher rate of growth in real per capita GDP after 1982, the U.S. performance showed the greatest improvement. In fact, the United States and the United Kingdom are the only two countries in which the recent average growth rates in real per capita GDP exceed their 1960-73 growth rates. And because of the outstanding performance in U.S. productivity and investment since 1982, the recent high growth rate of real per capita GDP still keeps the absolute real per capita GDP of the United States substantially higher than those of other G-7 nations (see Chart 2)

CHART 2

Real Per Capita GDP For the G-7 Nations



Source: Bureau of Labor Statistics, Office of Productivity and Technology, *Comparative Real Gross Domestic Product*, May 1988, (unpublished data). Each country's GDP is converted into U.S. dollars using the PPP exchange for total GDP.

Chart 2 shows per capita GDP in 1987 dollars for the G-7 nations. The real per capita GDP for the United States has been significantly higher than that of Japan, West Germany, and the average of Canada, France, Italy, and the United Kingdom.

The Relative Standard of Living Index

The relative standard of living index between the United States and other G-7 nations is constructed by dividing the U.S. real per capita GDP by the weighted average of the real per capita GDP of the other 6 of the G-7 nations, and then multiplying it by

100.[8] An index of 100 means the U.S. standard of living is about the same as the weighted average of the standard of living of those 6 nations. An index of more than 100 implies that the U.S. standard of living is higher than the average of the standards of living of the 6 nations. For example, if the index is 150, it means the U.S. standard of living is about 50 percent higher than the average of the 6 nations (see Chart 3).

CHART 3

Relative Standard Of Living Index

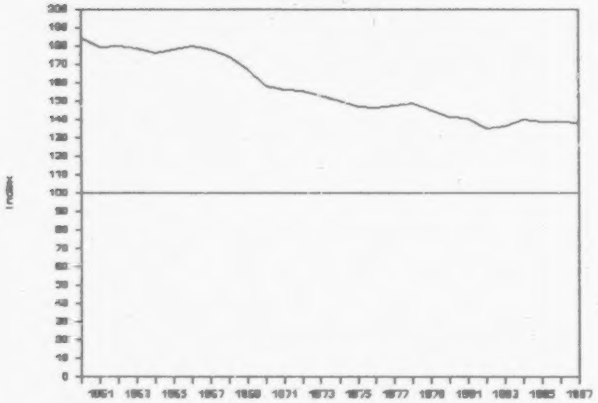


Chart 3 shows the relative standard of living index which was 184 in 1960, but eventually declined to its lowest point of 135 in 1982, before climbing to 138 in 1987. The relative index must be interpreted with great care. The decline in the index gives the inaccurate impression that U.S. performance is deteriorating while other countries are prospering. One reason for a decline in this index could be an absolute decline or a stagnation in the U.S. standard of living while other countries' living standards grow. Another reason for a decline in the index could be that the U.S. standard of living grows but those of other countries, many of which were destroyed by war less than 50 years ago, grow at faster rates. Since the latter, not the former, is the case, the "relative decline" of the United States has been exaggerated.

Nonetheless, this notion of the "relative decline" of the United States has led many people to believe that the prosperity of our trading partners has diminished our own affluence and, therefore, to accept the alleged loss of U.S. competitiveness. In fact, the prosperity of our trading partners provides expanded trading and investment opportunity for the American people. It is a myth generated by the politics of envy, not by the law of economics, that one person or country creates wealth at the expense of another. The U.S. position always has been that American freedom and prosperity are most secure when other countries are prosperous and free. It is in our self-interest to seek a more prosperous world. Only when the world is viewed through the green-tinted lenses of envy, can we believe the economic good fortune of our allies bodes ill for America. Thus, we should not let unfounded fears lead us to misread the facts.

Factors Determining Competitiveness

There is no basis for accepting the alleged loss of U.S. competitiveness if we examine those variables that contribute to a country's competitiveness, such as manufacturing productivity, investment, and research and development.

Productivity

The most popular measure of productivity in the context of competitiveness is manufacturing output per hour. It is generally agreed that the United States still has the highest productivity in absolute terms. There are, however, no official government statistics on the subject. The problem with comparing the level of productivity for different countries is that there is no suitable exchange rate to convert the value of manufacturing output in each country's currency into dollars. Some analysts have attempted to compare the absolute level of manufacturing output per hour. For example, the Council on Competitiveness uses PPP exchange rates to convert other G-7 nations' manufacturing output per hour into dollars. The flaw in this method is that PPP exchange rates, which are constructed for converting GDP only, are derived from the expenditure side of the national accounts (consumer, business, and government expenditure on final goods and services) and not from the output side of the account (gross product by industry). In fact, PPP exchange rates by industry are not available. Data Resources, Inc. constructed PPP exchange rates based on selected final expenditures by consumers and businesses to convert foreign currency data into U.S. dollars.[9] Although this method provides a better approximation of a PPP exchange rate for the manufacturing sector than the method used by the Council on Competitiveness, it still includes more than value added by manufacturing firms. To circumvent the problem of the appropriate PPP to use, the Bureau of Labor Statistics uses GDP per employed person as a proxy for productivity in comparing the absolute levels for different countries. According to this approach, the United States has the highest level of GDP per employed person (see Table 3).

TABLE 3

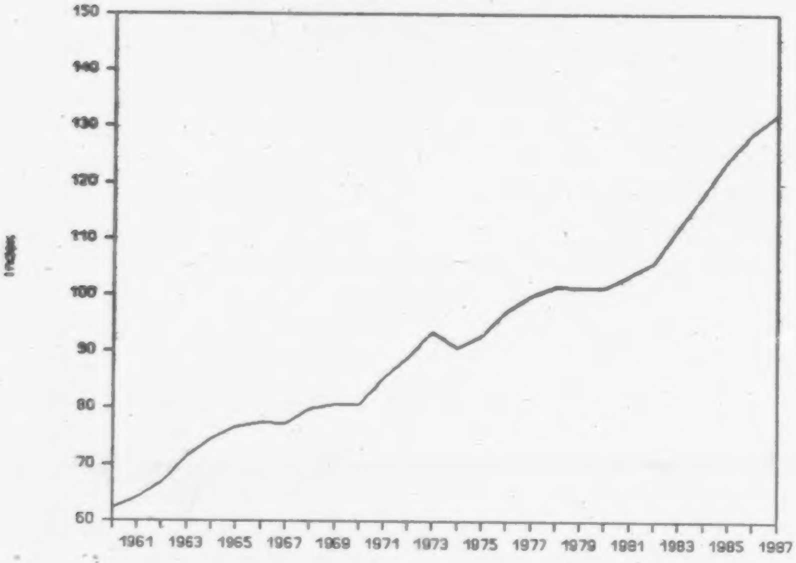
Real GDP Per Employed Person in 1987
(U.S. 1987 Dollars, PPP Exchange Rates)

Canada	$37,150
France	33,171
Japan	27,508
Italy	33,259
U.K.	27,982
U.S.	38,896
W. Germany	31,546

Source: Bureau of Labor Statistics

Compare to past performance, U.S. manufacturing productivity has improved dramatically during the 1980s (see Chart 4).

CHART 4



U.S. Productivity Index (1977 = 100)

Chart 4 shows U.S. productivity measured by manufacturing output per hour, indexed so that 1977 = 100. The index has improved dramatically since 1982.

Since a reliable international level comparison of manufacturing output is not available, only trends or growth rates are compared. The average annual growth rate in manufacturing productivity tripled its rate over the 1970s, significantly outstripping productivity growth abroad; as a result, the actual level of U.S. manufacturing productivity has improved substantially over that of other major industrial countries (see Chart 5).

CHART 5

Manufacturing Output Per Hour
Average Annual Growth Rate

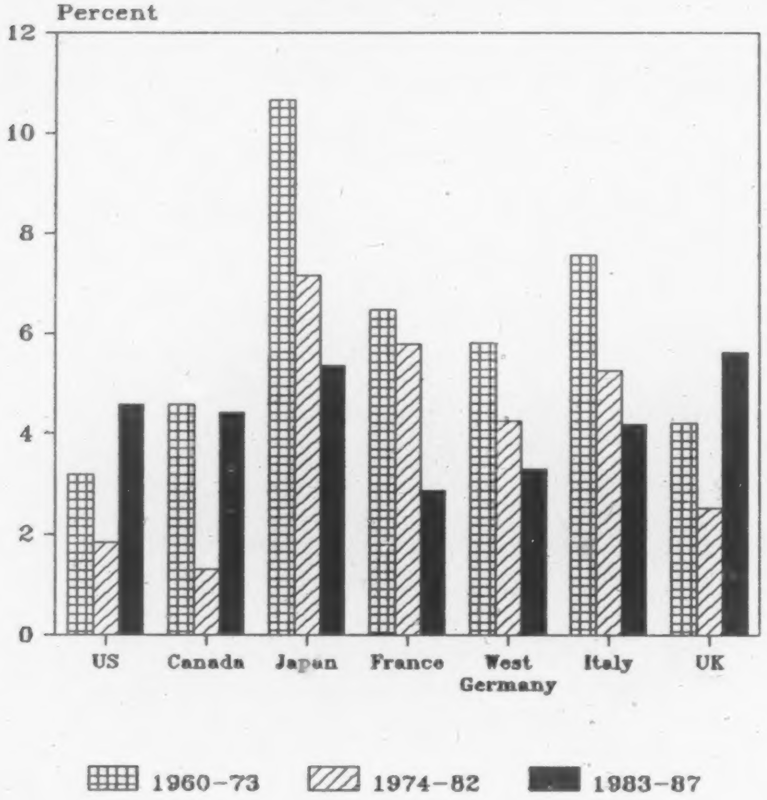


Chart 5 compares the average annual rate of growth in manufacturing productivity for the United States to that of other G-7 countries in 3 subperiods. The average annual rate of growth of U.S. manufacturing productivity was among the lowest in the G-7 countries at 1.84 percent during the 1974 to 1982 period. Between 1983 and 1987, however, the average growth rate in manufacturing productivity was among the highest of those countries at 4.57 percent. While other countries' growth rates of the recent period have been falling from the previous period, the growth rates of Canada, the United States, and the United Kingdom have been increasing.

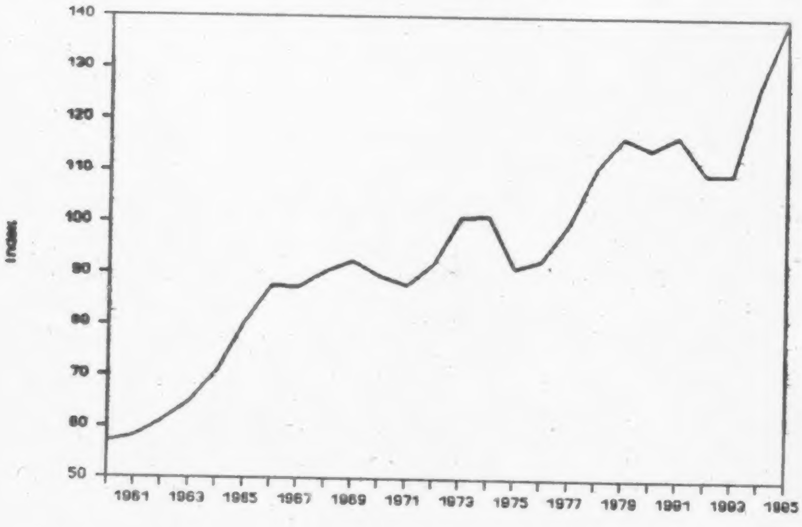
Investment

The U.S. investment outlook shows tremendous improvement and is more favorable than that of Japan and Europe. The variable usually observed is real nonresidential gross fixed capital formation (or nonresidential gross fixed investment) which is composed of real values of nonresidential construction and producers' durable goods. It shows how much new nonresidential investment, after adjusted for inflation, occurs during the year[10] (see Chart 6).

Chart 6 shows the index of nonresidential gross fixed capital formation in 1985 dollars from the years 1960 to 1985. Between 1983 and 1985, nonresidential gross fixed investment grew at an annual rate that was more than triple that of the 1973-82 period (1985 is the most recent year the data are available).[11]

CHART 6

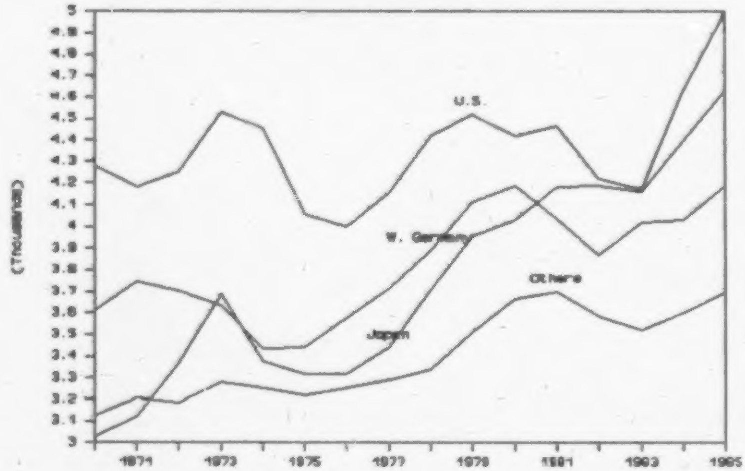
U.S. Nonresidential Gross Fixed Capital Formation Index (1977 = 100)



For international comparisons of the level of investment, the levels of nonresidential gross fixed investment per worker are compared. In the United States, investment per employed person fell dramatically between 1974 and 1982. At the same time, investment per employed person in Japan continued to rise and leveled off close to the U.S. level in 1982. But between 1983 and 1985, the U.S. level rose sharply at about 5.9 percent per year, compared to 2.8 percent in Japan during the same period. Consequently, the U.S. level is still above Japan's, West Germany's, and the average of the rest of the G-7 countries (see Chart 7).

CHART 7

Nonresidential Gross Fixed Capital Formation Per Employed Person



Source: Bureau of Labor Statistics, Office of Productivity and Technology, *Real Gross Fixed Capital Formation (Excluding Residential Buildings)*, October 1987, (unpublished data). Each country's data are converted from its own currency to U.S. dollars by using the PPP exchange rate for capital formation.

Chart 7 shows nonresidential gross fixed capital formation per employed person, which is a proxy for the amount of capital available per worker, between 1970 and 1985 (not all data in all countries are available before 1970).

Research and Development

Research & development (R&D) also plays a role in determining productivity and quality performance. R&D expenditures are often reported as ratios of GNP. Some analysts argue that because of the relatively large size of the U.S. service and agricultural sectors, the ratio of R&D expenditures to GNP gives a downwardly biased impression of the U.S. research and development effort in manufacturing, the sector that is more crucial for competitiveness than the others.[12] A more suitable indicator suggested is the ratio of industrial research and development as a percentage of manufacturing sales. In 1979, this percentage was 1.51 for the United States, compared to 1.49 for Japan and 1.67 for West Germany. The U.S. percentage grew considerably during the 1980s, and has been higher than that of Japan and West Germany since 1982. In 1985, the U.S. percentage was 2.39, while percentages in Japan and West Germany were 2.24 and 1.99 respectively.

The National Science Board also reports that in the United States, R&D has enjoyed vigorous growth recently. Between 1980 and 1985, R&D expenditures in the United States increased by 74 percent, compared to 36 percent in West Germany, and 69 percent in Japan.[13] In 1986, R&D expenditures in constant dollars entered its 10th year of continuous expansion at a 5.9 percent increase over 1985. Therefore, the renewed R&D effort in the United States should continue to boost competitiveness in the future.

Conclusion

There is no basis to accept the alleged loss of U.S. competitiveness. Real per capita disposable income and median family income reached a record-high level in 1987. The American standard of living continues to be the highest in the world. American labor productivity in manufacturing improved dramatically during the 1980s. In recent years, the investment outlook for plant, equipment, and producer durables has shown tremendous improvement, while investment in research and development has also enjoyed vigorous growth. Thus, the data do not suggest that in recent years, the United States has slipped either in absolute terms or relative to other countries. To the contrary, the data suggest that American competitiveness is resurgent, and that America indeed is entering a period of relative increase in its competitiveness.

Footnotes

[1] See for example, *Competitiveness Index*, Council on Competitiveness, 1988; *The Cuomo Commission Report*, The Cuomo Commission on Trade and Competitiveness, 1988; *Reassessing American Competitiveness*, National Planning Association on Changing International Realities, 1988.

[2] Susan Hickok, Linda A. Bell, and Janet Ceglowski, "The Competitiveness of U.S. Manufacturing Goods: Recent Changes and Prospects," Federal Reserve Bank of New York *Quarterly Review*, Spring 1988, pp. 7-22.

[3] The PPP exchange rates are calculated by the Organization for Economic Cooperation and Development (OECD) and the United Nations International Comparison Project (UNICP). Individual price surveys of a specified basket of goods and services of each country are compared to determine the PPP ratio for the year 1985. Using 1985 as the benchmark, the data are extrapolated to determine the PPP of other years.

[4] *Competitiveness Index*, Council on Competitiveness, 1988.

[5] The current account balance consists of balance on goods and services, income on foreign assets, government pensions, private remittances and other government and private transfers.

[6] The G-7 countries are the United States, Canada, Japan, France, Italy, and the United Kingdom.

[7] *OECD Employment Outlook*, September 1987, p. 28.

[8] The relative standard of living index is calculated by using the following formula:

$$\text{Relative Index} = (\text{U.S. per capita GDP}/\text{sum}(w^{*}\text{per capita GDP}_i))^{*}100,$$

where per capita GDP_i is per capita GDP of each of the six countries (Japan, Canada, France, West Germany, Italy, and the U.K.) and w is the weight of each of the six countries, determined by share of the country GDP, for example, weight of Japan is Japan's GDP divided by the sum of the GDPs of all the above six countries.

[9] Nigel Gault, "The Competitiveness of U.S. Manufacturing Industry: International Comparison of Labor, Energy, and Capital Costs," *Data Resources, Inc.*, 1985.

[10] No distinction is made between new investment for replacing old capital equipment and other new investment. In order to make any international comparisons of investment, the only PPP exchange rates that are available are for total capital formation.

[11] The Bureau of Labor Statistics is working on the revised and updated series.

[12] Susan Hickok, Linda A. Bell, and Janet Ceglowski, "The Competitiveness of U.S. Manufacturing Goods: Recent Changes and Prospects," Federal Reserve Bank of New York *Quarterly Review*, Spring 1988.

[13] *Science and Engineering Indicators,* National Science Board, 1987.